Are Inflation Adjusted Stablecoins Safe?

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As inflation soars it takes away the purchasing power of fiat currencies. Unfortunately for investors, inflation and higher interest rates tend to reduce the value of many investments as well. One refuge for those who buy US Treasuries are Treasury Inflation-Protected Securities (TIPS). These are government issued securities that are indexed to inflation. These have become very popular as inflation has raged. Now there is a version of the TIPS in the crypto world in stablecoins. TIPS are secured by the US government. Are inflation adjusted stablecoins safe?

Cryptocurrencies Are Not Hedges Against Inflation

Prior to the onset of the brutal **crypto winter**, proponents of cryptocurrencies argued that Bitcoin and other crypto tokens were a good way to hedge against inflation. It was repeatedly said that crypto was a safe way to protect wealth when social unrest and war swept the world. Then inflation hit its highest level in four decades, the US Federal Reserve and other major central banks began to raise interest rates and Russia invaded neighboring Ukraine setting off a chain of dire **economic and social effects**. Crypto tokens like Bitcoin fell to a third or even a fourth of their previous values. The only ones that maintained value against the dollar were stablecoins backed by hard currencies. Those supported by algorithms all too **often failed**, taking client assets with them.

How an Inflation Adjusted Stablecoin Works

Be In Crypto recently published information about the role of **stablecoins in combating inflation**. Stablecoins are crypto tokens that are linked to the value of a currency like the US dollar or even to a commodity like gold. They come in two varieties. One has dollar for dollar assets in reserve to guarantee the value of the stablecoin. The other uses a computer algorithm to influence trading and value of the stablecoin to help maintain its value versus the dollar and other currencies. Many use a combination of cash reserves and an algorithm. An inflation adjusted stablecoin uses a computer algorithm in an attempt to increase token values by the same rate as inflation in order to maintain purchasing power.

Algorithm Seeks to Adjust Stablecoin Value to Match CPI

As noted in the *Be In Crypto* article, the Volt protocol used for the Volt token is designed to track the CPI (consumer price index). If the CPI shows a 7% inflation rate the protocol of the stablecoin for a dollar is set to $1.07. The issue for inflation adjusted stablecoins is that when they have matching deposits in dollars they are not going to fall in value versus the dollar. Rather they will match it. However, as inflation eats away at purchasing power the dollar devalues against the cost of living by the rate of inflation. The TIPS Treasuries compensate by raising interest rates so that an investor earns interest to compensate for a weaker dollar. An inflation adjusted stablecoin is designed to increase its value against the dollar in order to compensate for inflation.

Algorithmic Stablecoin Risks

The rationale for using stablecoins in decentralized finance is that a stablecoin will maintain a stable value for investments, loans, or any financial transaction. The reason why many **crypto businesses went bankrupt** in the last year was that while the owners bet on crypto always going up against the dollar it fell badly. Such was not the case with most stablecoins. However, some stablecoins crashed. These were algorithmic stablecoins that did not have a substantial reserve of hard currency. With these tokens there is always a point at which market incentives and price manipulation are **overwhelmed by external forces**. Here is where we see the risk of an inflation adjusted stablecoin should inflation become so persistent and strong that it overwhelms the algorithm. In addition, the use of the algorithm to make the token more and more valuable in dollars means that the reserve of dollars becomes steadily less able to compensate when the market value of the token is threatened.

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