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WEALTH BLUEPRINT

THE SILENT DRAG ON WEALTH
Inflation & Purchasing Power

KEY POINTS

- Inflation gradually erodes purchasing power, reducing the real value of cash over time.
- While cash and time deposits provide nominal stability and liquidity, they may still generate negative real returns due to inflation.
- A diversified portfolio of suitable investment assets can help investors preserve purchasing power and improve the potential for positive real returns over the long term.

What is Inflation?

In everyday conversation, **inflation is often described simply as "rising prices."** More precisely, it refers to the rate at which the prices of goods and services increase over a given period. In the Philippines, inflation is primarily measured using the Consumer Price Index (CPI), which monitors price movements within a fixed basket of goods and services typically used by an average Filipino household.

However, focusing solely on price tags overlooks a much more important economic reality: **inflation represents the steady erosion of your money's purchasing power.**

Figure 1. Conceptual Illustration: The "Shrinking shopping cart"

Imagine holding a Php500 bill over several decades. While the number printed on the bill never changes, its actual purchasing power weakens. What Php500 could buy a decade ago requires a much larger budget today and will cost even more in the future.

This is why inflation is often described as a "silent tax." It does not appear explicitly on any statement, yet it continuously reduces the real value of cash savings.

What Causes Inflation and How is it Controlled?

To formulate an effective defense against inflation, we must first understand the primary forces that drive inflation, and how central banks step in to keep it contained.

The two main drivers of inflation:

- **Demand-pull inflation ("too much money chasing too few goods")**: This occurs when consumer demand grows faster than businesses can produce. A classic example was the post-pandemic reopening story. When lockdowns ended, people rushed to spend their savings on travel, food, and retail. This surge in demand overwhelmed businesses and sent prices soaring.
- **Cost-push inflation ("rising costs passed to consumers")**: This happens when the cost of raw materials or wages spike, forcing companies to increase their prices to survive. This is usually triggered by supply chain disruptions or geopolitical shocks (such as conflicts in the Middle East).

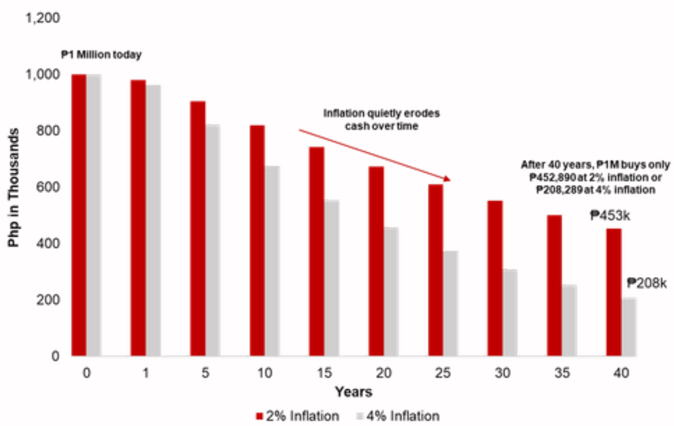
The Role of Central Banks and Interest Rates

Central banks, like the Bangko Sentral ng Pilipinas (BSP), act as the primary defense against runaway inflation using two main tools to maintain price stability. The first and most common is the adjustment of overnight interest rates. When inflation runs too hot, the central bank raises interest rates, making borrowing more expensive for households and businesses, which naturally dampens spending and lowers market demand. The second tool is managing the money supply through Quantitative Tightening (QT), where the central bank pulls excess cash out of the banking system to slow down an overheating economy. Conversely, if the economy stalls, the central bank cuts rates or increases the money supply via Quantitative Easing (QE) to encourage spending and credit creation.

Investing as your Primary Defense

Cash is not always king. While holding cash may feel safe because the balance in your bank account stays intact, inflation can quietly erode its purchasing power over time.

Figure 2. Effect of Inflation on Purchasing Power



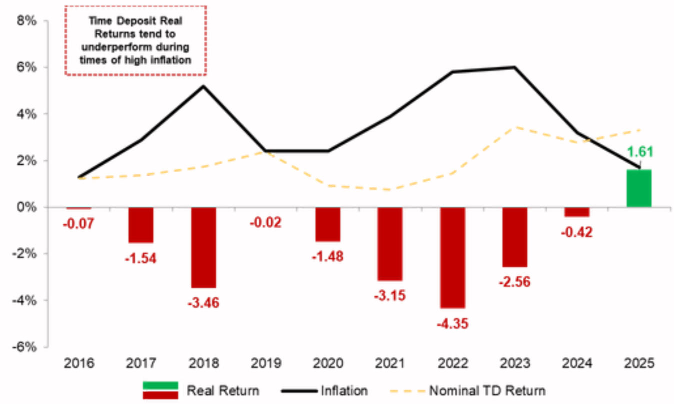
If inflation is 2% a year, the purchasing power of your money can fall by more than half over 40 years, and inflation can be higher than that. The BSP targets inflation within a 2% to 4% range, which means the threat to cash can be even greater.

However, cash still plays an important role as a buffer for emergencies. Additionally, when inflation rises, savings rates often rise too, making cash look more attractive. But even then, holding too much cash for too long can hold you back, while investing gives your money a better chance of keeping up with, and potentially beating, inflation over time.

The Illusion of Return: Real vs. Nominal

A key challenge in evaluating investment performance, especially during periods with heightened inflation, is distinguishing between nominal and real returns. Nominal returns, such as the stated interest rates on time deposits (TDs), create an impression of steady and positive income; however, when adjusted for inflation, these returns frequently reveal a far less favorable reality. For instance, a TD offering a 4% annual yield may appear attractive in isolation, but if inflation is running at 3.5–4.0%, the investor's real return is effectively negligible, if not negative. This phenomenon reflects the persistence of "money illusion," where investors focus on absolute gains rather than purchasing power. The issue is further exacerbated by taxation, which is applied to nominal income rather than real gains, thereby reducing after-tax returns below the inflation rate in many cases.

Figure 3. Nominal vs Real TD Returns (2016-2025)



Source: Bangko Sentral ng Pilipinas Selected Domestic Interest Rates 180-360 days

Inflation Fighters: Assets That Have Historically Outpaced Rising Costs

When inflation rises, investors often look to assets such as equities, real estate, and commodities because they may offer some protection against the erosion of purchasing power. These assets can respond to inflation in different ways: companies with strong pricing power may be able to pass higher costs to customers, real estate may benefit from rising rents and property values, and commodities are often directly linked to the prices of essential goods such as energy and food. However, none of these assets is a guaranteed shield against inflation. Commodities can be volatile, equities can fall when costs and interest rates rise, and real estate can be pressured by higher borrowing costs. **The key point is that these assets may help investors manage inflation risk, but their effectiveness can vary depending on market conditions.**

Actionable Insights: Moving From "Safety" (Cash) To "Security" (Assets That Grow)

For many investors, cash and time deposits feel safe because their principal remains stable in nominal terms. However, during inflationary periods, true financial security requires looking beyond the account balance and focusing on whether money can preserve and grow its purchasing power over time.

A practical approach is to use a two-basket framework. The first basket should serve as an emergency cash cushion for short-term needs and unexpected expenses. This protects liquidity and reduces the risk of having to sell long-term investments during unfavorable market conditions. The second basket should hold excess liquidity that can be gradually deployed into income and return generating investments, such as equities, bond funds, REITs, dividend-paying stocks, or balanced funds, depending on the investor’s objectives and risk profile.

Automated investing can strengthen this approach by helping investors manage market-timing risk and build long-term discipline. By investing regularly, investors participate across different market conditions instead of waiting for the perfect entry point. Dividend reinvestment can further enhance compounding, as cash distributions are used to buy additional shares or fund units over time. For fixed income instruments, a ladder strategy can be useful by staggering maturities across different periods. This helps preserve access to liquidity while allowing portions of the portfolio to be reinvested at prevailing rates.

Ultimately, the objective is not to eliminate cash but use it intentionally. Cash remains important for liquidity and stability, but surplus funds should be positioned in a way that gives investors a better chance of generating positive real returns and protecting purchasing power over the long term.

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