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The Myth of Price Stability and Inflation as a Hidden Tax

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Abstract: The primary goal of the Central Bank is to achieve price stability through the implementation of monetary policy. Price stability is met when the inflation rate is kept low and stays within the target set by the Central Bank. On the surface, the outcomes that occur from the pursuit of price stability are expected to be normal consequences from the implementation of monetary policy. However, it is extremely important to examine these outcomes particularly under the goal of price stability and to look beneath the surface to determine if the attainment of such a goal is indeed improving living conditions for all individuals in the economy. Findings of the paper reveal that there is no price stability even if the Central Bank sets the inflation target at 2 to 4 percent. The occurrence of at least 2 percent inflation still leads to an increase in prices and will accumulate over several years, which substantially reduces the purchasing power of the peso. The accumulated inflation in the Philippines over the last 18 years is at 84.246 percent and translates to an average of 4.67 percent per year which is definitely above the upper limit of the Central Bank inflation target. When the past 24 years are considered, the accumulated inflation is at 140.22 percent with the average per year at 5.84 percent which is worse. Price stability can only be achieved if the inflation rate is close to zero percent and this will only be possible if fiscal deficit spending as a practice is abolished. The fiscal deficit spending undertaken by the national government and its funding by the Central Bank through the creation of fiat money (whether in paper or in electronic form) is the real source of inflation. Inflation is a hidden tax because it is the cost as well as the burden imposed by government on all individuals in the economy when it finances its fiscal deficits by borrowing from a Central Bank that creates new money out of nothing.
Key Words: inflation; monetary policy; price stability; fiscal deficit spending; hidden tax

1. INTRODUCTION

The primary goal of the Central Bank is to achieve price stability through the implementation of monetary policy. Price stability is met when the inflation rate is kept low and stays within the target set by the Central Bank. The Bangko Sentral ng Pilipinas (BSP) has consistently set the inflation target at a range of 2 to 4 percent over the past several years, after being able to move past the double digit inflation periods which occurred from 1979 up to 1985, 1988 up to 1991 as well as in the year 1994. When the goal of price stability is achieved, the Central Bank puts itself in a position to pursue its next goal of creating conditions that will promote sustained economic growth through the use of expansionary monetary policy.

However, when inflation remains high, this requires the Central Bank to impose contractionary monetary policy which involves reducing money supply growth (and in severe cases a reduction in actual money supply levels to stop hyperinflation), and raising interest rates which leads to a recession. Under this situation, the goal of creating conditions for sustained economic growth cannot be pursued unless inflation is kept under control.

On the surface, the outcomes from the pursuit of price stability are expected to be normal consequences coming from the implementation of monetary policy. However, it is extremely important to examine these outcomes and to look beneath the surface to determine if the attainment of such a goal is indeed improving living conditions for all individuals in the economy.

2. METHODOLOGY

A description and discussion of the outcomes occurring from the pursuit of the goal of price stability will be presented using the data obtained from the Asian Development Bank Key Economic Indicators Report for Asia and the Pacific, the Philippine Statistical Authority Report as well from the Bureau of Treasury Report on the National Government Debt.

3. RESULTS AND DISCUSSION

3.1 The Myth of Price Stability

The Central Bank asserts that price stability is achieved when the actual inflation rate is well within the inflation target which was traditionally set at 2% to 4%. From the year 2006 up to 2023, this target was achieved eleven (11) times over a period of 18 years. The seven (7) years wherein they failed to meet the inflation target was in 2006 at 5.5%, 2008 at 8.3%, 2009 at 4.2%, 2011 at 4.6%, 2018 at 5.2%, 2022 at 5.8% and 2023 at 4.3%(projected).

However, even if the inflation target was met 11 times during the 2006 to 2023 period, the fact remains that prices still increased even if inflation stayed within the range of 2% to 4%. Even if prices only increased by 2% per year, the fact remains that goods and services have become more expensive and that the purchasing power of money has decreased. The damaging effects of inflation are more severe when observed across a longer period of time when price increases accumulate and have a greater impact on the fixed income of workers, pensions of the elderly and savings deposits in banks.

Using the sample period covering 2006 to 2023, and with the assumption that the base year is set at 2006 (where the consumer price index (CPI) is at 100), it can be observed that the CPI has been continually increasing each year over the past 18 years.

Year	Inflation	CPI
2006	5.5	100
2007	2.9	102.9
2008	8.3	111.4
2009	4.2	116.1
2010	3.8	120.5
2011	4.6	126.1
2012	3.2	130.1352
2013	2.6	133.5187
2014	3.6	138.3254
2015	0.7	139.2937
2016	1.3	141.1045
2017	2.9	145.1965
2018	5.2	152.7467
2019	2.5	156.5654
2020	2.64	160.6987
2021	3.9	166.966
2022	5.8	176.65
2023	4.3	184.246

*Inflation rates from 2006 to 2021 were obtained from the Asian Development Bank Key Economic Indicators Report of 2019, 2020, 2021 and 2022.
**The inflation rate for 2022 and 2023(projected) were taken from the Philippine Statistical Authority Report
***The Consumer Price Indices from 2012 to 2023 were recomputed using the base year value of 100 in 2006

The consumer price index had increased by 84.246 percent from the year 2006 up to 2023, which clearly indicates the absence of price stability and the continuing effects of a sustained increase in prices for the 18 year period. This outcome is no different from hyperinflation, except that it is done in slow motion. A reduction in the purchasing power of the Philippine peso is clearly shown as 84.246 percent of its value has been lost from 2006 to 2023 and the sectors that are most severely affected by the price increases are the elderly who are heavily dependent on fixed pensions, fixed income earners who are not provided with inflation adjustments in their wages and salaries, the poor who survive on very low incomes and individuals with savings accounts that have interest rates that are always substantially lower than the annual inflation rate. The value of savings is practically stolen by the accumulated inflation over the 18 year period.

Inflation reports by the statistical authorities have generally concealed the accumulated inflation by continually adjusting the base year consumer price index every six years (for example, in the years 2000, 2006, 2012 and 2018). On each occasion that the base year is adjusted, at most only 6 years of new accumulated inflation is shown, beginning from the new base year where CPI=100. This practice hides the effect of accumulated inflation contributed by the years prior to the newly designated base year.

The significantly large reduction in the purchasing power of the peso brought about by the accumulated inflation of more than 84 percent over the past 18 years also translates to an annual average inflation rate of 4.67 percent which is above the upper limit of the inflation target set by the Central Bank during the same period. If the year 2000 is used as the base year (CPI=100), the consumer price index for 2023 would be at 240.22. This indicates that prices have risen by 140.22 percent during the last 24 years with the average per year at 5.84 percent. This outcome is practically a version of hyperinflation in slow motion substantially reducing the purchasing power of money.

Year	Inflation	CPI
2000	6.7	100
2001	5.3	105.3455
2002	2.7	108.2138
2003	2.3	110.691
2004	4.8	116.0365
2005	6.5	123.5984
2006	5.5	130.3781
2007	2.9	134.1591
2008	8.3	145.2412
2009	4.2	151.369
2010	3.8	157.1056
2011	4.6	164.4068
2012	3.2	169.6678
2013	2.6	174.0792
2014	3.6	180.346
2015	0.7	181.6084
2016	1.3	183.9693
2017	2.9	189.3045
2018	5.2	199.1483
2019	2.5	204.127
2020	2.64	209.5159
2021	3.9	217.6871
2022	5.8	230.3129
2023	4.3	240.2164

*Inflation rates from 2000 to 2021 were obtained from the Asian Development Bank Key Economic Indicators Report of 2019, 2020, 2021 and 2022.
**The inflation rate for 2022 and 2023(projected) were taken from the Philippine Statistical Authority Report
***The Consumer Price Indices from 2000 to 2023 were recomputed using the base year value of 100 in 2000

3.2 The inflation rate hides the higher price increases of other more important goods and services in the consumption basket

Aside from the accumulated inflation which is eroding the purchasing power of money, it is also important to consider that the inflation rate based on the overall consumer price index (CPI) generally hides the higher price increases of other more important goods and services in the consumption basket. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by consumers for a representative basket of consumer goods and services (Philippine Statistical Authority 2022). The computed CPI generates a value which will be within the lowest and the highest price indices of the commodities included in the basket (even if weights are assigned to the more important commodities). The computed CPI ultimately offsets the high price indices of certain commodities with the low price indices of the others, producing a value that falls within the upper and lower limits of the price indices in the basket of goods.

For example, the inflation rate from December 2021 to December 2022 was at 8.1 percent based on the percentage change in the CPI during the said period. Because the CPI combines all price indices of goods in the basket of commodities, the computed inflation rate of 8.1 percent ends up hiding the fact that: 1) Food and non-alcoholic beverages increased by 10.2 percent; 2) Flour bread, other bakery products and pasta increased by 10.9 percent; 3) Milk and other dairy products and eggs increased by 9.9 percent; 4) Sugar, confectionary and desserts increased by 38.8 percent; 5) Ready-made food and other food products not elsewhere classified increased by 9.4 percent; 6) Corn increased by 26.3 percent; 7) Oils and fats increased by 19.2 percent and; 8) Alcoholic beverages and tobacco, 10.7 percent (Philippine Statistical Authority, 2022).

The other commodities in the basket that show lower price increases (that tend to offset the higher price increases mentioned earlier) include: 1) Meat and other slaughtered products which increased by 7.4 percent; 2) Fish and other seafood by at 6.3 percent; 3) Clothing and footwear at 3.9 percent; 4) Furnishings, household equipment and routine household maintenance at 4.8 percent; 5) Housing, water, electricity, gas, and other fuels at 7.0 percent; 6) Health at 3.1 percent; 7) Recreation, sport and culture at 3.9 percent; and 8) Restaurants and accommodation services at 7.0 percent (Philippine Statistical Authority, 2022).

In view of the high price increases of certain goods being offset by the lower price increases of the other commodities, the final consumer price index produces a number within the lowest and the highest price indices in the basket. This consequently leads to an inflation rate that significantly understates the true increase of prices in the most important commodities purchased by the households.

In effect, the reduction in the purchasing power of the peso is actually greater than what is shown by the annual inflation rate as well as by the accumulated inflation rate over several years.

There is no real general price level. Prices of different goods and services do not change to the same extent at the same time. There are always prices that are changing more rapidly, rising or falling more quickly than other prices (Mises, 1979)

3.3. The misleading conventional definition of inflation

Inflation today is conventionally defined as a condition of sustained price increases occurring in the economy (Mankiw, 2012). This definition is misleading because it hides the true cause of inflation and may attribute rising prices to other factors such as wage increases, bad weather or world oil prices which are not the true causes of sustained long term prices increases.

Wage increases do not cause inflation but is simply the consequence of higher inflation. This is actually the response of labor unions to rising inflation in an attempt to catch up with the higher cost of living (Friedman, M. and Friedman R. 1990).

Bad weather such as severe flooding and or droughts may cause supply shortages and price increases in the short term but these are normally offset by the importation of cheaper agricultural products from other countries which reduces prices within months. The only reason why this solution does not immediately lower agricultural prices in the Philippines is because government limits importation by reducing the number of import licenses being issued to firms which get this special privilege. In effect, it is not a cause of inflation but the outcome of bad government policy.

World oil prices are in foreign currency (U.S. dollars) and any price increases in U.S. dollars are completely independent of the issuance of Philippine currency. The only connection between the U.S. dollar and the Philippine peso is the exchange rate. Exchange rates are affected by expansionary monetary policy which raises aggregate demand, increases importation, and leads to an exchange rate depreciation, making oil imports more expensive (Friedman, M. and Friedman R., 1990). Countries such as Germany and Japan which import all of their crude oil, do not have high inflation from rising world oil prices and their exchange rates do not depreciate. In effect, it is not the world oil prices that cause inflation but the depreciation of the exchange rate attributed to expansionary monetary policy which consequently makes the imports more expensive in local currency (Friedman, M. and Friedman R., 1990)..

3.4 The classical liberal definition of inflation which has been proven true over time and across countries

The classical liberal definition of inflation refers to the increase in money supply that causes a sustained increase in prices (Reed, 2012). This is the definition which has proven to be true based on the fact that rapid inflation and specifically hyperinflation has occurred in various countries at different periods, and in all cases, were attributed to the rapid growth of money supply used to finance massive government spending that exceeded tax revenues. These are the experiences of countries such as Zimbabwe in 2008 (89.7 sextillion percent), Greece in 1942 to 1944 (8.5 billion percent) , Bolivia in 1984 to 1986 (20,000 percent), Argentina in 1989 (4,923 percent) , Brazil in 1994 (2,075 percent), Chile in 1971 to 1973 (1,200 percent), Russia in 1992 to 1994 (2,520 percent) , Austria in 1921 to 1923 (1,426 percent), Germany in 1920 to 1923 (1 trillion percent) and the Ukraine in 1993 to 1995 (1,400 percent), just to mention a few (Mankiw, 2012).

In theory, the rapid increases in money supply which cause inflation are illustrated by the "Quantity Theory of Money" which states that the total spending on the amount of goods and services produced in the entire economy (P*Q) can only be undertaken if there is a quantity of money (M) that is created and is adequate enough to facilitate the expenditures. The quantity of money multiplied by the velocity of money (V) will be equal to the total spending on all goods and services produced in the entire economy. The equation is presented as follows:

$$M*V = P*Q$$

Where: M is the quantity of money
V is the velocity of money (or the number of times money is turned over)
P represents all the prices of the 1st product(i) up to the last product(n)
Q is the quantity of each product (from product(i) up to (n))
P*Q is the total spending on all products (goods & services) in the economy

Assuming that the velocity of money (V) and the quantity of products (Q) are stable, an increase in the quantity of money (M) will result to an increase in the prices of goods and services (P). This occurs particularly when the growth of the amount of goods and services (Q) fail to catch up with the rising demand for products caused by the increase in the quantity of money(M) (Friedman, M. 1987).

3.5 Inflation as a Hidden Tax

Based on the classical liberal definition of inflation (where sustained price increases are caused by increases in money supply), it now becomes necessary to understand why money supply is increased and how it is released into the economy.

Money supply is increased because it is used to finance the excess of government spending over taxation. This is referred to as fiscal deficit spending. Government is capable of spending more than the amount of tax revenues it collects because of its ability to borrow money from the Central Bank which has the sole authority to create and print new money out of nothing and simply require a government bond issued by the Bureau of Treasury in order to back it up (Salerno, 2000).

Government can issue bonds and directly borrow from the Central Bank (monetizing public debt) and or borrow from commercial banks (public borrowing) based on directives from the Central Bank. However, commercial banks consequently sell these government bonds to the Central Bank in order to get access to new money at artificially low interest rates. Therefore the government bonds issued to the commercial banks end up being used by the Central Bank to back up the newly created money. This practice remains faithful to the condition that newly created money must be backed up by government issued treasury bonds.

Fiscal deficits have always been increasing except for the years 1994 up to 1997 when actual surpluses were reported by government. Outside of this three year period, the fiscal deficits have been getting larger from P49B in 1998 to P134B in the year 2000 to P314B in 2010, P353B in 2016, P1.651T in 2022 and P1.453T projected by the end of 2023. Presented below are the fiscal deficits for the past eight years from 2016 to 2023.

	Fiscal Deficit	Government Spending	Tax Revenue
2016	P353.422B	P 2.549 T	P2.196 T
2017	350.637 B,	2.823	2.473
2018	558.259 5B,	3.408	2.850
2019	660.236 B,	3.798	3.137
2020	1.371 T	4.227	2.856
2021	1.671 T	4.675	3.005
2022	1.651 T	4.954	3.633
2023	1.453 T	5.086	3.633

Source: (Bureau of Treasury Report Dec, 2022). Figures for 2023 are projected.

The increasing fiscal deficits funded by Central Bank money creation and backed up by government bonds are responsible for the existence of high and rising inflation (Greaves, 2021).

When the Central Bank creates new money, it increases the demand for goods and services by the recipients of the new money which are both government and borrowers from the private sector. Considering that there is no accompanying increase in the amount of goods and services being produced when new money is created, prices continually increase. When output production fails to catch up with the rising demand, this inevitably results to a higher inflation rate.

New money injected by the Central Bank and spent by the national government into the economy has an inevitable ripple effect; the early receivers of new money (government and private contractors) spend more and bid up prices, while later receivers (the rest of the private sector) or those on fixed incomes find the prices of the goods they must buy unaccountably rising, while their own incomes lag behind or remain the same (Rothbard, 2023).

Inflation is a policy used by the government , and such a policy can be changed by not inflating the money supply and balancing the budget of government (Mises, 1979).

Because newly created money finances excessive government spending (or fiscal deficit spending), its inflationary outcome which is expected to be within 2 to 4 percent (or perhaps, above it) becomes the inflation tax or a hidden tax. Ideally, all government spending should be financed by tax revenues. However, because government can borrow from a Central Bank that creates new money out of nothing, the inflationary outcome becomes the cost of government's actions shouldered by all individuals in the economy in the form of higher prices (Reisman, 2003). If the ruling political party does not want to imperil its popularity by the imposition of immediate heavy taxation, it takes recourse to inflation (Mises, 1944).

British economist John Maynard Keynes actually wrote that "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens" (Keynes, 1919, Reed, 2012).

3.6 The Direct Relationship between Money Supply and Public Debt

Since all of the new money being created by the Central Bank should be backed up by government bonds/debt, the increasing fiscal deficit spending which requires more money creation will lead to larger levels of public debt, that accumulates over several years and will require more taxation in the future in order to pay for it. This is the reason why new tax reform programs are implemented roughly every ten years for the purpose of improving tax revenue collections that will pay for the continually growing public debt.

Money Supply Growth, Level and Total Public Debt

Money supply has always been increasing after the end of the second world war and funding fiscal deficits have been undertaken after the establishment of a Central Bank in 1948. In the current millennium, money supply (M3) increased from P1.427T in the year 2000 to P2.919T in 2006 and P9.506T in 2016 (ADB Selected Key Economic Indicators Report 2021). A sample of money supply growth and the actual money supply level (M3) is provided below from 2016 to 2022. During this period, the highest money supply growth is at 12.8 percent (in 2016), while the lowest is at 7.9 percent (in 2022), with the money supply level increasing from P9.506T in 2016 to P16.555T in 2022.

M3 growth %		M3 (Money Supply)	Total Public Debt
2016	12.8	P 9.506 T	P 6.603 T
2017	11.9	10.636	7.103
2018	9.5	11.643	7.780
2019	11.5	12.976	8.220
2020	9.6	14.222	10.253
2021	7.9	15.343	12.162
2022	7.9	16.555	13.430

*M3=currency in circulation + demand deposits + savings deposits + time deposits + government securities
*Money supply growth and levels were obtained from the ADB Selected Key Economic Indicators Report 2021
*Public debt figures were taken from the Bureau of Treasury Report on Government Debt 2022.

The public debt has grown from P2.8T in 2001 to P4.4T in 2006, P6.6T in 2016 and P13.430T in 2022. Rapid increases in money supply (M3) will increase the public debt and lead to more taxation. Regardless of how much of this debt is a percentage of the gross domestic product, the fact always remains that the burden of payment (taxation) will always be passed on to all individuals in the economy. This means a continued reduction in the freedom of people to use their hard earned income to make their lives better, more meaningful and productive.

4. CONCLUSIONS

There is no price stability even if the Central Bank sets the inflation target at 2 to 4 percent. The occurrence of at least 2 percent inflation still leads to an increase in prices and will accumulate over several years which substantially reduces the purchasing power of the peso. The accumulated inflation in the Philippines over the last 18 years is 84.246 percent which translates to an average of 4.67 percent per year and which is definitely above the upper limit of the Central Bank inflation target. When the past 24 years are considered, the accumulated inflation is at 140.22 percent with the average per year at 5.84 percent which is worse. Price stability can only be achieved if the inflation rate is close to zero percent and this will only be possible if fiscal deficit spending as a practice is abolished. The fiscal deficit spending undertaken by the national government and its funding by the Central Bank through the creation of fiat money (whether in paper or in electronic form) is the real source of inflation. Inflation is a hidden tax because it is the cost as well as the burden imposed by government on all individuals in the economy when it finances its fiscal deficits by borrowing from a Central Bank that creates new money out of nothing. The value of money is taken away from income earners and savers as inflation occurs and accumulates over several years . Money creation to fund fiscal deficits will also lead to the accumulation of public debts and the imposition of new taxes and higher tax rates in order to pay for such debts. Public debt has always been increasing and regardless of how much of it is a percentage of gross domestic product, the fact will always remain that every individual will have to pay more of both direct and indirect taxes every year in order to settle these government obligations.

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