Figuring out inflation

Discover what inflation means for your family and how you might guard against its impact

The price changes of these goods and others are used to work out the rate of inflation

Inflation occurs when the prices of goods and services rise. And unless your income and savings keep pace, your purchasing power shrinks and your savings are eroded.

Recent rises

We haven't had to worry much about inflation in recent years, with an average rate of less than 3 per cent (as measured by the retail price index – RPI, see below) for ten years. But it has started to rise: the latest figure as we went to press was 4.4 per cent.

Going up

Energy costs have been blamed for much of the increase. But while gas and electricity prices rose by 25 per cent in 2006 (reflecting supply shortages, increased global demand and cold weather) new gas supplies have helped the inflation rate for 'fuel and light' fall back, to 4.7 per cent by June 2007.

Fresh vegetables cost 11.3 per cent more this summer compared with June 2006

Other items that have outstripped the average rate of inflation the most are:

- Housing: up 10per cent
- Fares/other travel costs: up 8.3 per cent
- Household goods: up 5.1 per cent
- Food: up 4.8 per cent.

The rise in housing inflation is due to the continuing demand for, and shortage of, property, while people are paying more of their income for homes and higher mortgage interest rates.

The reasons behind rises in other categories can be more difficult to account for, though rail fares have certainly been influenced by money spent on modernisation and by increasing numbers of people travelling, while postage costs (under household goods) have risen by 12.6 per cent since June 2006, due in part to the modernisation of the Post Office.

Bread was up by 8.1 per cent, while fresh vegetables cost 11.3 per cent more in June than the same time last year. It might be that the supermarkets' push to drive down prices from suppliers has gone as far as it can – not helped by fuel prices and erratic weather and the fact that there is less land for crops as populations increase.

Going down

Items that fell over the same period were:

- Audiovisual goods: down 13.4 per cent
- Leisure goods: down 2.8 per cent
- Clothing/footwear: down 0.3 per cent.

Continuing technological advances mean audiovisual goods can be produced for less, and prices are kept down as more companies move production overseas.

A personal rate

But what do these rates mean for you? There are concerns that the true rate of inflation is underestimated, and there are also arguments about whether the traditional RPI or the consumer price index should be the main measure used (see left).

A survey of Which? members showed that 52 per cent thought their personal rate of inflation was higher than average (see 'Our research', p34).

Karen Dunnell, of the Office for National Statistics (ONS), says: 'Figures are based on average spending patterns, but every household is different, and how inflation affects them depends on their spending.'

To help people understand how inflation affects them, the ONS launched an online personal inflation calculator (www.statistics.gov.uk/pic) earlier this year.

We asked readers with different family and financial situations to calculate their personal inflation rate (see opposite), so they could compare it with the national rate and possibly review their spending habits.

Measuring the change in prices

Each month the inflation rate is based on the change in prices of around 650 popular goods and services that make up an inflation shopping basket, which is updated each year. But there's disagreement about which specific index should be used

RETAIL PRICE INDEX (RPI) This long-standing measure is used to set pensions and benefits, and to negotiate most public-sector pay rises. Categories include clothing, motoring and leisure services. This year, items added to the basket were olive oil, probiotic drinks, DAB radios, mobile phone downloads and satnavs, while vegetable oil, Brussels sprouts, VHS video recorders and 35mm compact cameras were withdrawn.

CONSUMER PRICE INDEX (CPI) This covers similar categories to the RPI, but excludes mortgage interest payments, depreciation, council tax and house insurance, and calculates inflation differently. The government uses CPI to set inflation targets (it's similar to European indices) and began to use it for some public-sector pay rises in 2006. But some criticise it for being misleadingly low. In June, RPI was 4.4 per cent while CPI was 2.4 per cent.

PHOTOGRAPHY ALAMY, ROBIN BECKHAM, ALASTAIR FYFE, JOHN TRENHOLM, SIMON WRIGHT

CHECKING OUT PERSONAL INFLATION RATES

We tried out the new Office for National Statistics online inflation calculator on a family, a student and an older couple. The calculator asks for spending in several categories, turning each figure into a percentage of total expenditure. It works out how inflation has affected each category and, by adding them together, calculates a personal rate. For our case studies, we highlight their personal rates and some of their main areas of spending in the charts below

The family

Inflation rate 6.5%

Tax adviser Angela Williams, 49, and her 51-year-old husband Steve, a chemical engineer, have three teenagers

Our family's rate was much higher than the June RPI rate of 4.4 per cent. However, for 2006 their rate was 3.8 per cent, closer to the RPI of 3.2 per cent.

Angela and Steve have paid off the mortgage and run two cars, but an increasing expense is the children's school fees.

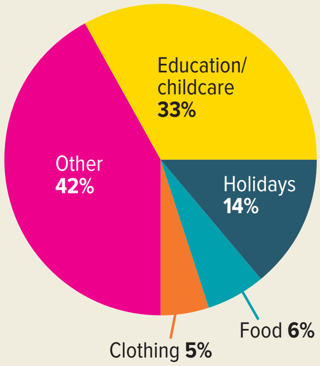
ONS figures show that the recent inflation rate for education and childcare, which covers fees, has been more than 14 per cent.

And as the calculator showed, school fees comprised 33 per cent of the Williams' expenditure, so these figures explain their higher-than-average inflation rate.

It could have been even higher, but other categories in which they have spent a fair amount, such as holidays, cars and clothing, have fallen in recent months.

Angela says: 'Our proportions of spending are an eye opener – more each month on fees than in a year on rates and home insurance...it's food for thought.'

The Williams' spending



The student

Inflation rate 4.9%

Jenny Scott-Thompson, 20, is a second-year student of mathematics at the University of Cambridge

During term time, Jenny lives in halls of residence, so much of her spending has gone on rent (48 per cent). She also spent a lot on academic fees – 15 per cent – which also comes under the education and childcare category that has affected the Williams family.

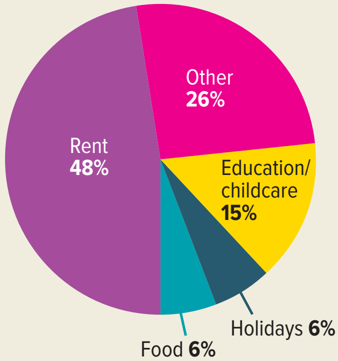
With a calculated inflation rate at just below 5 per cent, Jenny slightly exceeds RPI, but the gap was even narrower in 2006, when her rate was 3.4 per cent.

Jenny's personal inflation figure has been kept higher by a steep increase in student fees but eased by her rent rising less than RPI.

Other outgoings have shown modest increases, but food, accounting for 6 per cent of spending, has gone from a rate of 2.1 per cent at the start of 2006 to around 4.8 per cent more recently.

If the inflation rate is worrying, Jenny could consider a Best Buy student account – Halifax has an interest-free overdraft of £2,750.

Jenny's spending



The older couple

Inflation rate 5%

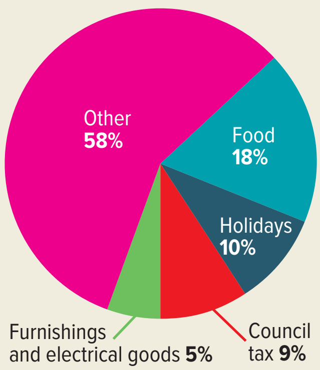
Jean and Frank Weller are both in their 70s and retired

The Wellers' personal rates of 5 per cent for 2007 and 3.9 per cent for 2006 were both fairly close to the national rates of 4.4 and 3.2 per cent, respectively.

Their main outgoings are food, home fuel, holidays and council tax. As with student Jenny, a recent change that has pushed up the Wellers' inflation rate is the increase in the price of food, which makes up 18 per cent of their spending.

Heating and lighting make up 6.9 per cent of spending and could have pushed their rate higher, but fuel prices have fallen more recently. They have redecorated their home recently and bought new furniture, but their outgoings on furnishings and electrical items have barely increased their rate, as this category has risen by only 0.9 per cent this year and 1.3 per cent in 2006. As redecoration is a one-off, outgoings in this category should fall further.

The Wellers' spending



2007 and pie-chart calculations based on June 06 to June 07 spending, and June 07 inflation rate; 2006 calculations based on January to December 06 spending and December 06 inflation rate

The Yorkshire Building Society offers an inflation-beating 7.1 per cent to those who save regularly

Why inflation matters

As our case studies show, rising prices affect us all differently. But it's not only spending that counts – what's also important is how much income increases at the same time.

People on a fixed income, like pensioners, can be hit hard, and even modest imbalances between prices and earnings cause problems. For example, if prices rise 5 per cent each year while your salary rises by 2.5 per cent, the purchasing power of each £100 you earn falls to £78 in ten years.

Countering the effects of inflation can be challenging. Using tools like the ONS calculator to review spending can help – but only to an extent: you need to look at your savings and investments as well.

Safeguarding savings

For savings to beat price rises, you need to earn higher interest than the inflation rate. And consider tax: basic-rate taxpayers have 20 per cent deducted from gross interest, while higher-rate taxpayers lose 40 per cent.

So if a basic-rate payer puts £100 into an account paying 6 per cent, the return after tax will be £4.80, or 4.8 per cent. For a higher-rate payer, the return is only £3.60, or 3.6 per cent, which is lower than the June RPI figure of 4.4 per cent.

Rising inflation makes it more important than ever to check rates on savings accounts; while many banks have failed to pass on recent interest rate rises, some accounts do offer more than 6 per cent.

OUR RESEARCH
In March 2007, we asked 2,677 members of our online panel how they thought their rates of inflation compared with the national average. Fifty-two per cent said it was above, 35 per cent said about the same, 6 per cent thought it was lower, while the rest didn't know.

Our Best Buy Chelsea Building Society account currently offers 6.4 per cent, while Sainsbury's Internet Saver Bank pays 6.25 per cent (see p36).

And it's possible to get higher rates on savings accounts, such as 7.1 per cent with the Yorkshire Building Society, by committing to regular savings.

Even higher rates can be offered on accounts tied to other products. Alliance & Leicester is currently offering 15 per cent to those who combine regular savings with a mortgage, but this is only for one year, after which it reverts to 6.1 per cent.

Tax-free solutions

One way to make the most of savings is to hold them in a tax-free cash Isa, into which you can pay up to £3,000 a year (rising to £3,600 next April), without paying tax. Such savings funds are not guaranteed to outstrip inflation, however, so you still need to check rates carefully.

Another solution is tax-free savings linked to inflation. National Savings & Investments (NS&I) index-linked certificates currently pay 1.35 per cent ahead of RPI and you can invest for three or five years.

Risky rewards

But for many savers and investors, the way to defeat inflation by a clear margin is to take a higher risk. Investing in stocks and shares often produces inflation-beating returns, particularly in the longer term – more than ten years – but it also carries the possibility of losses.

Unit trusts can spread your risk over a wider range of shares, but they're still subject to market fluctuations; if markets crash, you may struggle to beat inflation over the period in which your money is tied up.

National Savings & Investments index-linked certificates pay 1.35 per cent ahead of inflation

Property growth

Property investment has helped people beat inflation in recent years. Average house prices are rising at around 10 per cent a year and some owners have seen their homes triple in value over the past decade.

Investors have turned to buying to let as a way of tapping into this growth (see p28). This isn't without risk, however, and steep rises in interest rates have led some to predict a crash in the housing market.

Pension planning

Long-term pension savings can be particularly vulnerable to inflation and need to achieve real growth. If you need to invest your pension pot on retirement, because you have a personal or stakeholder pension, you'll have to weigh up the pros and cons of receiving a fixed income by investing in a level annuity, or an increasing income through an escalating annuity.

Escalating annuities cost more to buy and pay out less each month at the beginning, while those on fixed incomes have a steady loss of spending power, particularly in times of higher inflation – so make sure you shop around for the best deal.

Don't panic

Despite the recent pick-up in RPI, it's not certain that inflation will continue to rise significantly. Utility prices have already begun to fall and, hopefully, inflation will stabilise.

Some of us will continue to bear the impact of inflation more than others, but for most it's swings and roundabouts.

The ONS calculator has limits; its broad categories of expenditure don't exactly reflect the individual items we buy and it doesn't tell you explicitly which specific areas of spending have the highest inflation rates, but it can help you understand what drives your overall personal rate.

Reviewing your spending, together with searching for inflation-beating savings and investments, could help you begin to tackle the challenge of rising prices.

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