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AN INTRODUCTION TO

How inflation impacts your finances

GETTING TO GRIPS WITH THE BASICS

Measuring inflation

The impact of high inflation

What is 'Bank Rate'?

Purchasing power

Impact on savings

Investment potential

Following a sustained period of historically low inflation, the upsurge in price pressures in recent times highlighted the impact inflation can wreak on people's finances. Although inflation looks to be slowing, it is important to have an understanding of it and the impact it has on your wealth. Here, we consider these issues and look at the potential benefits of longer-term investment as a way of protecting your money from the effects of inflation.

Inflation is a term used to describe the increase in the general level of prices for goods and services over time, with the rate of inflation quantifying how quickly prices are rising. There is no single approach to measuring inflation, partly as figures differ depending upon which specific bundle of goods and services are included in the calculations. However, the Office for National Statistics (ONS) publishes a number of consumer price indices each month which provide its latest estimate of inflationary trends. The UK's official headline measure is the Consumer Price Index (CPI) 12-month rate which compares prices in the current month with the same period a year earlier.

MEASURING INFLATION

A good way of understanding how a price index works is to think of an extremely large shopping basket containing a mix of the various goods and services a typical household buys – the price index basically shows changes to the overall cost of that basket over time. For the CPI, prices for around 700 things people regularly buy are recorded each month. These cover a variety of items including a loaf of bread and ready-meals, the cost of a cinema ticket and a pint at the local pub, as well as larger items such as a holiday and a car. To calculate the index, ONS compares the current cost of the basket with what it was a year ago - the change in price level is the annual rate of inflation.

THE IMPACT OF HIGH INFLATION

A healthy economy generally requires inflation to be low and stable. While a small amount of inflation is considered helpful, high and unstable rates can cause extreme economic difficulties as it erodes the purchasing power of household finances and makes it difficult for people to plan how much they can spend, save or invest. In the UK, the government has a 2% target for how much prices should go up each year with the Bank of England tasked with keeping the figure around that level. The Bank's principal tool for maintaining a low and stable inflation rate is to raise or lower interest rates.

WHAT IS 'BANK RATE'?

Bank Rate is the most important interest rate in the UK and has a significant impact across many aspects of the economy. It is sometimes referred to as the Bank of England Base Rate and is set by the central bank's nine-member Monetary Policy Committee. The rate directly influences other interest rates, including the lending and savings rates high street banks and building societies offer their customers. The level of the Bank Rate therefore ultimately determines both the cost of mortgages and loans, and how much people can expect to receive on savings held in deposit-based accounts.

INTEREST RATES AND INFLATION

Economic theory shows there is an 'inverse' relationship between inflation and interest rates: in other words, when interest rates are low inflation tends to rise, and when rates are high inflation tends to fall. This is because high interest rates make it more expensive for people to borrow money and encourages them to save, which means they typically spend less on goods and services, and this results in prices rising more slowly; and vice versa. So if prices are deemed to be increasing too rapidly, the Bank of England will typically raise interest rates in order to try to slow inflation down.

A healthy economy generally requires inflation to be low and stable

PURCHASING POWER

When the rate of inflation is low, its impact can seem relatively modest, but when inflation is high it can drastically erode the purchasing power of money. For example, if the rate of inflation is 1%, then the price of a loaf of bread that cost £1 a year ago would now be £1.01. However, if inflation is running at 10%, the price of the same loaf would rise to £1.10. In other words, households can buy less for the same amount of money or, to put it another way, money has effectively lost value.

Inflation makes things more expensive over time.

IMPACT ON SAVINGS

Inflation has a similar devaluing effect on deposit-based savings balances. For instance, a saver who held £10,000 in a building society account a year ago earning a rate of 1%, would receive £100 in interest and thereby see their total balance rise to £10,100. However, if inflation was running at 10% then the same £10,000 worth of goods and services that could have been bought a year earlier would now cost £11,000. So, although the saver may feel they have earned £100, when factoring in the effects of inflation, the value of their cash savings has actually declined by £900 in real terms.

INVESTMENT POTENTIAL

While cash savings will always be important, particularly as a source of rainy-day funds, in the current economic climate people holding a large proportion of their assets in cash look set to lose money in real terms. For anyone planning to put money aside for a number of years, it may therefore be worth considering investments as a potential way to protect capital from the effects of inflation. Although past performance is no guarantee of future profits, stock market investments have tended to produce returns that could potentially inflation-proof money over the longer term, providing savers are prepared to take some degree of risk.

HERE TO HELP

We're only a phone call away, so if you have any questions or would like to discuss any aspect relating to the impact of inflation on your finances, please get in touch.

The value of investments and income from them can go down as well as up. You may not get back the original amount invested. Past performance is not a reliable indicator of future performance.

TAX-EFFICIENT INVESTMENTS

As well as potentially offering protection from inflation, some investment products also enjoy significant tax advantages that make them particularly attractive investment propositions. Both pensions and stocks and shares ISAs fall within this category.

PENSIONS

Investing via a pension is one of the most tax-efficient methods of saving for the long term as investors receive tax relief at their highest marginal rate of Income Tax on all contributions made subject to annual and lifetime allowances. This means that some of your earnings which would have gone to the government as tax are instead diverted to boost your pension pot. This effectively results in it costing you less to save more in a pension plan.

STOCKS AND SHARES ISAs

Individual Savings Accounts (ISAs) are another tax-efficient investment option and provide greater flexibility than a pension as they allow access to your money before the age of 55. Investors can save up to £20,000 each tax year in a stocks and shares ISA with the money having the potential to grow free of UK Income Tax and Capital Gains Tax. These products can be a particularly good way to save for medium or long-term financial goals, such as a wedding or new car.

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Warning statement

It is important to take professional advice before making any decision relating to your personal finances. Information within this document is based on our current understanding and can be subject to change without notice and the accuracy and completeness of the information cannot be guaranteed. It does not provide individual tailored investment advice and is for guidance only. Some rules may vary in different parts of the UK. We cannot assume legal liability for any errors or omissions it might contain. Levels and bases of, and reliefs from, taxation are those currently applying or proposed and are subject to change; their value depends on the individual circumstances of the investor. No part of this document may be reproduced in any manner without prior permission.