

Inflation

Why we must stop it creeping up on us

The party's coming to an end for the moment. We're now seeing increasing interest rates to counteract rising inflation figures. Therefore, everyone hates the Bank of England and the Treasury. But that's their job. Just when everyone is enjoying themselves, borrowing to the hilt and spending to the limit, they come along and say 'enough is enough'.

A little bit of inflation is acceptable, say 2% a year. People know where they stand. Prices go up a little, pay settlements are modest and people feel a little bit richer and generally comfortable with things. However, once it starts getting out of hand all kinds of new pressures and uncertainties build up and the system starts to look a little unstable. That's where we are now and the Bank is trying to rein matters in before they turn nasty.

The story so far

A combination of cheap money over many years, encouraging people to spend, together with certain external price increases, like fuel and energy, have meant that inflation has drifted up recently and that people have been spending beyond their means. This will now require a re-appraisal of personal finances for many. Already credit card debt has been reducing over the past few months as individuals and families try to re-balance their income and expenditure, but large mortgage debt hangs over many and the implications of this are yet to be seen fully. There'll undoubtedly be pressure for higher pay settlements to compensate, but this just sets a spiral in motion and is certainly unhelpful for **in my primers**.

Those in retirement or approaching and planning retirement won't be helped by increased interest and inflation rates.

Implications

Like many others who have a mortgage, any increase in repayments will put a squeeze on finances. Furthermore, the kinds of costs which have been going up, utilities, food, council taxes, medical costs, and so on, form a greater

proportion of expenditure for older people than for younger ones and so their effective inflation rate is considerably higher than the published ones. This is now being tracked by certain financial institutions. The older generation has probably taken less advantage of cheap imports, manufactured in Asia, like clothes, computers and audio equipment. With a bit of luck some of the rises on these essential costs, like gas and electricity, have peaked and they may even actually fall in future months.

For those on fixed incomes there is no opportunity to compensate for the increase in costs by increasing income and so the imbalance becomes very apparent very quickly. Even for those with company pensions, the wide-scale problem of under-funding of schemes means that many providers will not feel able to increase pensions fully in line with inflation.

For those saving for their pension and looking to retire in the near future, the spectre of inflation is a particular dampener. You may have saved enough for a £1000 a month pension but, at 4% per year inflation, that £1000 will be equivalent to only £450 in 20 years' time. (Remember what you used to receive in pocket money and how much it would buy!). This is not an insurmountable problem but must be built into the equation.

Bear in mind that, if you can earn 5% a year on your investments but inflation is running at 3% then, roughly speaking, your 'real' rate of return is only 2%. 3% out of your 5% has to be ploughed back into your investment pot just to keep up its purchasing power in the future. And it's your 'after tax' investment return that you should be looking at – the cash that you get to provide the cash to spend!

And then there are the 'BOMADs' (those using the Bank Of Mum and Dad). We're now seeing an increasing number of children in their twenties (or thirties) who haven't left the family home or who've returned to it because they may have outstanding student loans and/or can't afford a place of their own and/or are looking to their parents to help them with a deposit to buy a

property. Poor Mum and Dad – yet another financial burden! So what's the solution?

As with most things there's not one magic answer and different ones will suit different people. However, there's no need to panic. This is a long term problem and calls for long term thinking.

Control Expenditure

Firstly, get your spending under control. See our primer '**Sink or Swim – breaking free of the spending spiral**' for some ideas.

These include cutting back on non-essential expenditure, at least in the short term. The general 'feel-good' factor of recent years has allowed many organisations to increase prices ahead of inflation and some activities are looking particularly expensive at the moment. Already we're seeing a drop in football attendances where the prices of tickets have been going up by as much as 17% (over 5 times inflation) in the recent past. Likewise, eating out has been on the increase and prices have been creeping up steadily.

As increased fuel charges are one of the main drivers of current inflation you can do yourself a favour and shake these companies out of their complacency by looking to changing providers, particularly if it's been more than a year since you last swapped.

Pulling in your highly expensive credit card debt will have quick and long lasting benefits. A little more effort, but worthwhile, is to become an 'interest rate tart', moving outstanding amounts to 0% interest deals and then moving on again before they run out (see Martin's Money Tips at www.moneysavingsexpert.com).

Look to finding a cheaper mortgage deal or extending the period of your loan is another possibility. Many people have opted for fixed interest deals in the last few years while money has been cheap and they're now protected from the increased costs. Unfortunately these cheap offers are now being withdrawn as interest rates rise.

Review savings and investments

Now is good time to review your savings and investments. Why do you have them in the form they're in? Are they offering the best returns around? How do they cope with inflation? Are they providing you with good **real** returns?

Take a look at our primers '**Understanding money**' and '**The ins and outs of investing**' and see how your investments measure up.

It may be efficient and provide peace of mind to use some of your investments to pay off some of

your debt. You'll need to look at the comparative returns of each of these.

If you own a property then you've probably done quite well just recently. House price inflation has been greater than general inflation and the returns on investment have been higher than the cost of borrowing. This may not last forever as money becomes tighter. Also, increased wealth is not the same as cash flow and the mortgage payments may still be hurting.

And, on its own, a high value house does not pay your food bill. So, as an **in my primer**, any gap between your planned retirement income and your planned expenditure may have to be filled by looking to your property to provide funds. Downsizing is one option while the notion of equity release (or reverse mortgages as they are called in America) is gaining much more mainstream attention.

There is a lot of suspicion (some deserved, some not) over these so make sure you read widely and understand what they're about. Two sites worth a visit are www.ship-ltd.org and www.unbiased.co.uk

Work-life balance

If you're still working then it's quite possible that you'll have to consider postponing outright retirement, or only moving in the direction of retirement over a period of time. As we've already said before there are many benefits to this, not just financial ones. See our primer on '**Portfolio Working**' for more on this.

And if you have a BOMAD living with you make sure that you don't 'kill them with kindness'. Providing a roof over their heads is one thing but you working yourself to a frazzle when you should be easing up is not a solution that's in anyone's interests. You don't want to make a profit out of your own children but they should be expected to help with certain costs like the housekeeping bills and maybe even some form of notional rent.

Otherwise, without the necessary financial discipline, they'll never get to grips with the real world and may find staying at home just a little bit too comfortable.

Conclusion

The control of inflation has been taken out of the political arena and the Bank of England is now responsible for controlling it, mainly by fine-tuning interest rates when necessary to take the heat out of the economy. That's where we are now and we must see what happens. In the meantime we must all take a view and – as responsible in my primers - make our own adjustments.