WHAT IS INFLATION?

An introduction to inflation and the context for the growing rate, the effect it has on our lives and the tools the Government have at their disposal to counter it.

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WHAT IS INFLATION?

In a market economy, the prices for goods and services can change drastically, rising and fall depending on a variety of factors.

The result of these price changes can often have either a positive or negative effect on people's quality of life, with buying power either being improved or restricted depending on the fluctuations in price.

Inflation occurs when prices rise due to increases in production costs, such as raw materials and wages.

Inflation also occurs when there is a large increase in the price of goods and services, not just of individual items.

What this means, is that buyers can buy less for £1 today than they could yesterday. In more basic terms, Inflation reduces the value of the currency over time.

Inflation is the economic measure of the rate of rising prices of goods and services. If high inflation occurs, it leads to high and has a negative impact on society through limiting people's ability afford not just luxuries, but essential goods and services like food, housing, utilities and medical care.

Once inflation becomes common throughout an economy, the expectation of further inflation becomes a conscious concern for consumers and businesses. The reaction to which, can often result in inflation spiralling even further.

A Market Economy – is an economic system in which production and prices are determined by unrestricted competition between privately owned businesses.

WHAT DOES HIGH INFLATION MEAN FOR ME?

High inflation means an increase in the cost of living. In simple terms you will be able to buy less items with the same amount of money than you did before.

But how much costs change will vary. The cost of some items will rise more than others.

What will make a difference is how much your overall cost of living changes compared to changes in your income. If prices go up but your income stays the same as it was a year ago, you'll notice it won't go as far as it did then.

HOW DO WE KNOW WHAT THE RATE OF INFLATION IS?

Each month the Office for National Statistics checks the prices of a range of items in a 'basket' of goods and services. They record the cost of over 700 things that people regularly buy. This basket includes everyday items such as a loaf of bread and a bus ticket. It also includes larger items, such as a car and the cost to go on holiday.

The price of the basket provides an overall price level. This is known as the Consumer Prices Index or CPI.

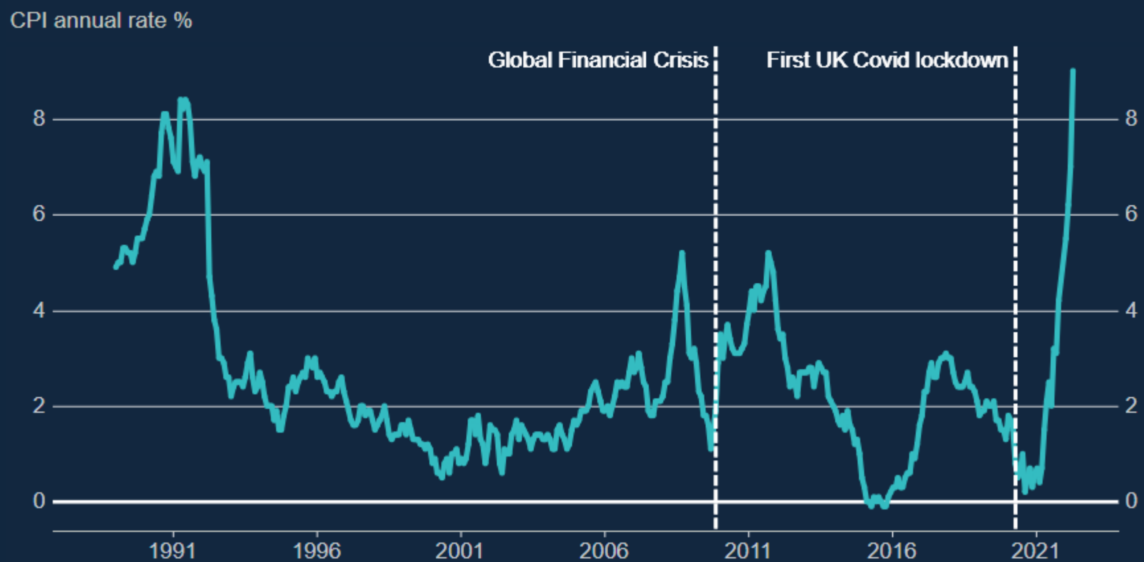
To calculate the rate of inflation, ONI compare the cost of the basket – the level of CPI – with what it was a year ago. The change in the price level over the year is the rate of inflation.

HOW HAS THE RATE OF INFLATION CHANGED OVER THE YEARS?

Inflation has gone up and down over the years. It is the Bank of England's (BOE) job to keep inflation at the Government's target rate of 2%.

This rate is set to indicate how much prices overall should go up each year in the UK.

Over the last 20 years, it has averaged 2%, but as you may have been able to tell by your purchasing power, it has been both higher and lower.



IS HIGH INFLATION A PROBLEM?

A low and stable rate of inflation helps to create a healthy economy in a market economy that relies on incremental increases to goods and services.

High and unstable rates of inflation are often harmful. If prices are unpredictable, it is difficult for people to plan how much they can spend, save or invest. In more severe cases, high and volatile inflation causes an economy to collapse.

An extreme example of this would be Zimbabwe who experienced an 80 billion per cent increase in a single month in 2007.

This resulted in people refusing to use Zimbabwean banknotes and the economy ground to a halt.

WHAT DOES THE BANK OF ENGLAND DO TO KEEP INFLATION STABLE?

The Bank of England (BOE) is responsible for setting a monetary policy – this is the set of tools used to keep inflation low and stable.

This is achieved through interest rates. Interest is the amount of money people will receive on any savings that they have. It is also the charge needed to pay on top of loans and mortgages.

WHAT IS THE LINK BETWEEN THE INTEREST RATES AND INFLATION?

High interest rates encourage consumers to save more as they can earn more interest on their savings.

This means that there is less demand for goods and services, so the prices will tend to fall (as was evidenced during the pandemic with the decreased cost of fuel).

When the rate of inflation is low. The opposite is also true.

Lower interest rates mean it's cheaper to borrow money, and there's less of an incentive to save. This encourages people to spend and increases the rate of inflation.

HOW DOES THE BANK OF ENGLAND INFLUENCE INTEREST RATES?

Interest rates work by making it cheaper or more expensive to borrow money, and by making it more or less attractive to save.

The Bank of England influence interest rates in two main ways:

1

Base Rate is set. This is the single most important interest rate in the UK because it influences all other interest rates.

2

The Bank of England can buy and sell bonds from financial markets. They will mainly buy government bonds, or 'gilts'.

Buying assets in this way is called quantitative easing (or QE). QE enables us to influence the interest rates on savings and loans.

The Bank of England expect for inflation to start to reduce from next year. The cost-of-living crisis is difficult for many. Inflation hits the least well off the hardest. The 2% target remains in place and it is their job to ensure that inflation returns to 2%.

WHY IS THE RATE OF INFLATION IN THE UK SO HIGH?

Prices have risen rapidly in the UK over the last year. The speed of that change in the price level is called the rate of inflation.

In June, prices had risen to 9.4% compared with one year ago, which is above the 2% target.

The rate of inflation is forecast to keep rising in 2022. However, there is an expectation for it to slow down in 2023 and return to close to 2% in two years.

The forecast is due to the main causes of the current high rate of inflation that are not likely to last, and because interest rates have been raised several times over the past few months.

However, even though the rate of inflation is expected to slow down, it may be the case that some prices remain at a high level compared with what people have been used to in recent history, during a period of mild inflation levels.

WHY IS THE RATE OF INFLATION IN THE UK SO HIGH?

Higher than normal energy prices are one of the main reasons of the current high inflation rate.

Russia's invasion of Ukraine has led to large increases in the price of gas. In fact since Q2 2022, the price of gas has doubled, with current forecasts expecting inflation to reach 13% in the next few months.

Above average prices for the commodities we buy from abroad have also played a big role.

During the peak of the Coronavirus pandemic, people started buying more goods. The sellers offering those goods had difficulties making enough of them to sell which led to higher prices – particularly for goods imported from abroad.

WHAT IS THE BANK OF ENGLAND DOING ABOUT HIGH INFLATION?

The UK Parliament task The Bank of England with keeping the rate of inflation at 2%. Increasing interest rates is main thing that can be done to bring the rate of inflation down.

The interest rate has risen since December 2021, with August's most recent increase reaching 1.75%.

Higher interest rates make borrowing more costly, and they encourage saving. Both of those things reduce how much people spend overall. This helps to push inflation down.

But higher interest rates don't work straight away. They take time to take full effect. And as such there is a further look at what will happen in the economy over the next few years, not just what's happening today.

All of these actions are working to ensure that inflation reaches 2%.

A BIT ABOUT QUANTITATIVE EASING...

Quantitative easing (or QE) acts in a similar way to cuts in Base Rate. It lowers the interest rates on savings and loans. And that stimulates spending in the economy.

HERE'S HOW QE WORKS:

BOE buy UK government bonds or corporate bonds from other financial companies and pension funds. When this happens, the price of these bonds increases meaning that the bond yield, or 'interest rate' that holders of these bonds get, goes down.

The lower interest rate on UK government and corporate bonds then feeds through to lower interest rates on loans for households and businesses. That helps to boost spending in the economy and keep inflation at target.

QE also affects the prices of other assets like shares and property. Here's an example. If BOE buy £1 million of government bonds from a pension fund. In place of those bonds, the pension fund now has £1 million in cash.

Rather than hold on to that cash, it will normally invest it in other financial assets, such as shares, that gives it a higher return.

In turn, that tends to push up on the value of shares, making households and businesses holding those shares wealthier. That makes them likely to spend more, boosting economic activity.

DOES QUANTITATIVE EASING WORK?

Yes it does. A number of studies have shown that QE can have a big impact on inflation and spending in the economy. We're not alone in the UK in using QE. It's also been used in countries such as the US, Euro area and Japan.

WHEN WILL INFLATION START TO FALL?

Current expectations are for inflation to reduce in 2023.

This is because there is an expectation that energy prices and the cost of imported goods will not continue to rise as rapidly as they have done. It is also expected that some of the production difficulties that businesses are facing will ease.

Less demand for goods and services in the UK should also push down prices.

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