



**Question –**  
*What have the following got in common? – hamsters, kiwi fruit, laptop computers, kebabs, replica football shirts, a full leg wax and sandals.*

**Answer –**  
 They are all part of the basket of goods used to measure inflation in the UK.

# Inflation – what it means to you

## Does one size fit all?

A growing number of people have been questioning the use of the official inflation measure as a reliable indicator of how the cost of living is changing for them as an individual. Any measure that seeks to reflect changes in the UK as a whole must, by definition, be a broadly based average, which then raises the question – Is there a Mr, Mrs or Miss average?

## What is inflation and why is it measured?

Inflation is the way we measure the changing cost-of-living in the UK and is something that the majority of us are only too familiar with having lived through the very high inflation rates of the late

1970s and the 1980s. Today's inflation rate of around 2%-3% is a far cry from 12%-13% of 1978-79 or the 1989-90 rate of 16.5%.

Measuring inflation is important as it is a key yardstick in assessing the health of the economy. The high levels of the '70's and '80's were a clear sign of an economy in trouble as was a Bank of England Base Rate which hit 15% in 1989 as the Government sought to regain control over runaway inflation. (This was before the Bank of England was given independence from the Government in 1997 by Gordon Brown and charged with delivering an inflation rate of just 2% per annum).

The rate of inflation plays an important role in

the economy through its impact on interest rates, wage negotiations, tax allowances, pensions and other state benefits, many of which are directly linked to inflation.

## A basket of goods and services is used to measure inflation...

The easiest way to think about inflation is perhaps to look on it as a 'shopping basket' containing all the goods and services on which we as consumers typically spend our money. Over time the cost of various items in the basket will change as does the total cost of the basket. Usually measured over a twelve month period, the

## In the UK there are 1 million fewer people in their twenties today than 10 years ago, and for the first time there are now more 55-64 year olds than 16-24 year olds.

### The times they are a changing...

The basket of goods and services is reviewed annually to ensure it remains 'representative' of UK spending, taking into account the goods and services purchased, the places in which we shop and the amounts we spend. For example, back in the 1950s, the index included chickens and mangles, while today it includes ready meals, dry cleaning and internet subscriptions.

The contents of the basket and the weight attributed to each item are primarily taken from the regular Family Expenditure Survey undertaken by the Office of National Statistics. The most recent changes took place in February 2006 and saw additions to the basket including:

- MP3 Player** – Replacing the CD player as representative of the personal audio market
- Flat screen TV** – Replacing widescreen TVs
- Exhaust fitting in fast fit centre** – To improve coverage of vehicle maintenance
- After school club charges** – To improve coverage of a growing area
- Music downloads** – To cover an emerging market not covered elsewhere
- Chicken kiev** – To represent the processed poultry market
- At the same time the following low-weighted items were amongst those removed.
- Sliced salami** – Cold meats adequately covered by other constituents
- Adult slippers** – Very low-weight within the index
- Baseball cap** – Low-weight and adequately covered by other constituents
- Flea drops** – Well represented by pet care products
- Bedside cabinet** – Removed so that home office desk could be included

These regular changes are designed to take into account our changing lifestyles and spending patterns.

### Collecting the data and ensuring like-for-like

Calculating inflation involves the comparison of a like-for-like basket of goods. To ensure consistency, 150,000 prices are collected around the middle of each month on a Tuesday from outlets across the country. The same outlets are visited month-in month-out.

You would think that this sounds a simple enough task, though clearly on a massive scale.

But it's not always the case, particularly where rapid technological change is taking place, as is the case with many electronic goods. Here one model is frequently replaced by another with a higher specification. In such circumstances a higher price may be warranted because you are getting more for your money and this is not regarded as adding to inflation. Consequently, prices will be adjusted to reflect any change in the quality of the goods in the basket. Elsewhere, goods may disappear – a particular problem with clothing and the influence of fashion. They then have to be replaced by a broadly similar offering so that prices are not distorted. An example of this in the 2006 changes was the replacement of girl's dresses with girl's trousers due to difficulty in collecting prices.

### What's the problem for us as investors?

As investors, nothing, it's more the expenditure that results from the life stage of many investors. The likelihood of anyone being 'average', irrespective of age is slim as we will each have our own unique basket of goods and services and our own rate of inflation. For example, on the basis that most investors are also home owners, does the Retail Prices Index (RPI), the most commonly quoted measure adequately reflect items such as council tax? According to the Halifax, since its introduction in April 1993, council tax bills have risen by 121%, compared to a 36% increase in the RPI. Also, it seems questionable whether the seemingly inexorable rise in gas and electricity bills are adequately represented.

Elsewhere, the Bank of England's latest inflation report highlighted increases in university fees as a significant contributor to the recent increase in inflation that triggered August's rise in interest rates. This is something else highly skewed in its impact on the population, as most parents of university students will testify! Some areas of expenditure are not even covered – according to the Harley Medical Group there has been a fourfold increase in 50 year olds having cosmetic surgery over the last five years – something yet to be included in the RPI basket.

With time, increased expenditure in these areas will be reflected in the RPI weightings as they feed through the Family Expenditure Survey, but until then we'll have to make the best use of what we've got.

### Conclusions

The RPI by definition can only ever be indicative – a best guess as to how prices are changing as inflation will affect us all differently depending on our lifestyle and life stage. But as we have seen it's a measure designed to evolve with time and the changing spending patterns in the UK.

percentage change in the total cost of the basket of goods and services is regarded as the prevailing rate of inflation.

To measure inflation a diverse basket of goods and services, currently some 650 items are used to represent spending by UK consumers. Obviously, we don't spend the same amount on each item so those which are the most important and on which we spend the highest amounts are weighted to reflect this. For example, a 20% rise in the price of petrol will have a much greater impact on our finances than say a 20% increase in the price of tea bags.