How rising inflation and low interest rates impact your money – and what you can do about it

a 5 minute read

Keeping all your money in a cash-based savings or deposit account, when inflation rates are rising and interest rates are low, means that your money is effectively losing value over time. Talk to your financial adviser about steps you can take to keep this from happening to your money. Read this short article to learn more.

Many people aren't sure exactly what inflation is or how it affects their cash. But it's important to understand this so that you can decide if you need to take action.

Put simply, if inflation is higher than the interest rate on your money in a cash-based savings or deposit account, the buying power of your money will go down over the long term. The result is that you'll be able to buy less with your money than you would have been able when you first started saving.

On the next two pages, we take a closer look at what inflation is, how it's managed, the impact of rising inflation and low interest rates on your money, and why you could consider investing any cash that you don't need in the short term (in the next five years).

Your financial adviser has given you this article to provide some more context about how rising inflation and low interest rates impact your money. We recommend that you read it and then get in touch with your adviser. They will be best placed to help you understand what investment options are right for you. **Please also bear in mind that the value of your investments can rise as well as fall, and you may get less back than what you invest.**

So what exactly is inflation?

Inflation refers to the increasing prices of goods and services we buy as consumers.

For example, if the cost of a pint of milk rises from £1 to £1.10 in a year, then 10p is the increase. This is an inflation rate of 10%.

How is inflation managed?

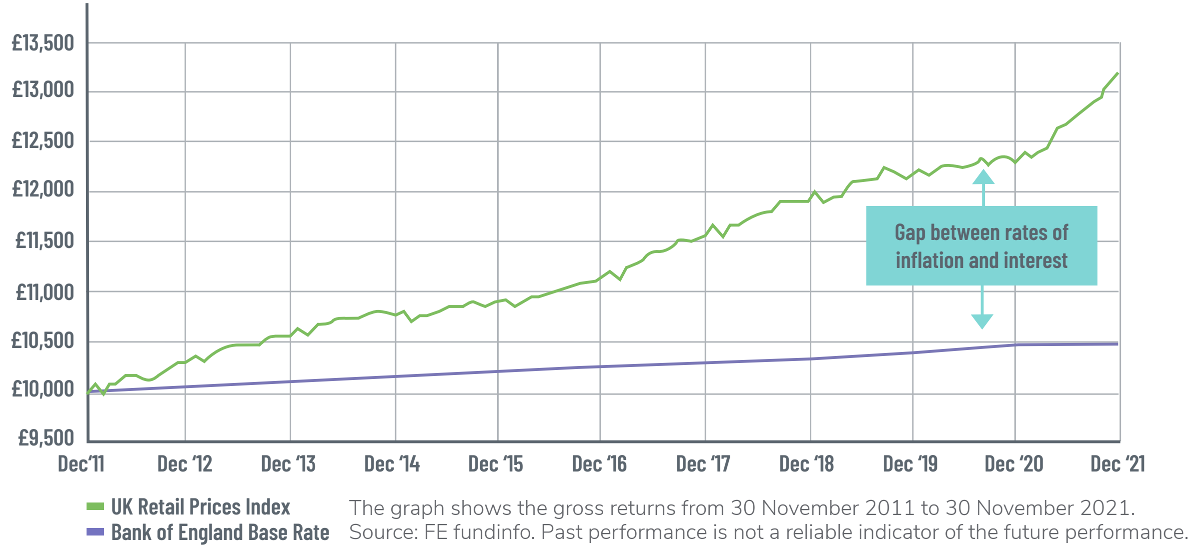
Governments take into account the inflation rate when making policy decisions. Inflation also impacts how state benefits, such as the state pension, will increase by each year. If prices are rising faster than a country's target inflation rate, the bank that sets the country's interest rates will consider raising the interest rate to maintain the inflation target. In the UK, the Bank of England is responsible for keeping inflation at the target set by the Government and it does this by managing interest rates. Higher interest rates encourage people to save and spend less, which means prices will rise more slowly and lower inflation. Lower interest rates mean it's cheaper to borrow money, making people spend more, which will increase inflation.

What impact do rising inflation and low interest rates have on your money?

While small price rises in goods and services might not be immediately noticeable, over the longer term these price rises can have an impact on what you can buy with your money. And when interest rates are lower than the inflation rate, the spending power of your cash-based savings declines.

The graph below shows the relationship between low interest rates and inflation. If you'd kept £10,000 in the bank for ten years, from 30 November 2011 to 30 November 2021, there would be very little growth in the value of your money. The purple line, which represents the Bank of England base rate, shows the change in the value. However, inflation (the green line) has increased significantly more in the same time frame.

The gap between inflation and interest

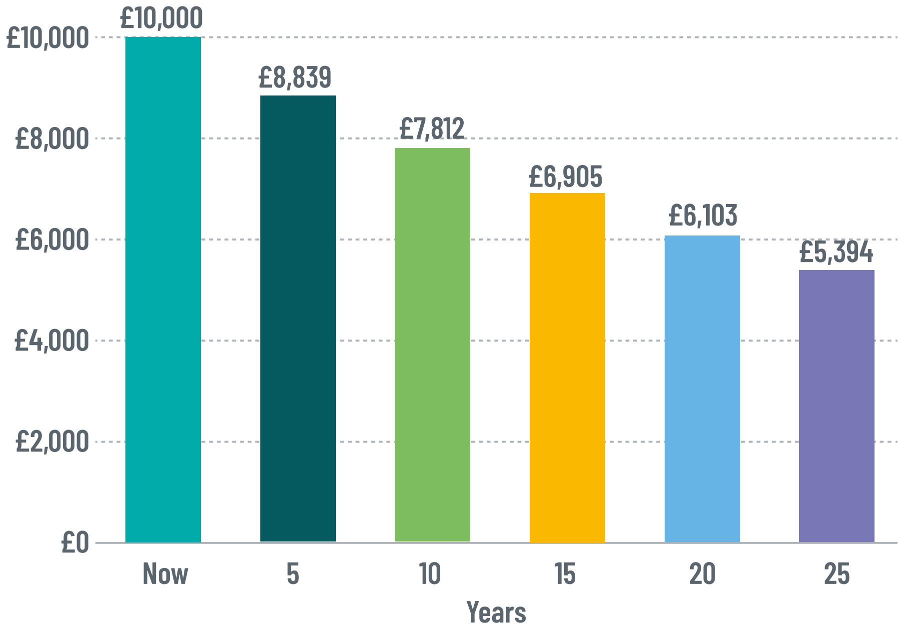


The graph shows the gross returns from 30 November 2011 to 30 November 2021. Source: FE fundinfo. Past performance is not a reliable indicator of the future performance.

What's most important to notice above is the gap between the green and purple lines. That's the gap between the interest rate and the inflation rate. What it shows is just how much your money's buying power would have declined during this ten-year period. And will continue to decline as long as interest rates remain below inflation.

Another way of looking at this is in the graph on the next page.

Inflation erodes the value of your money over time



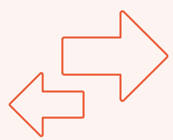
- This graph shows that if we assume 2.5% inflation each year, the purchasing power of £10,000 today could be worth just £5,394 in 25 years' time.
- The example shows an inflation rate of 2.5% but please note inflation can be more or less than this.
- The example also assumes that the sum has not grown over time as no interest has been added.

Find out more

Your financial adviser can talk to you about the effect inflation could have on your money in a bank or savings account. And you can use the Bank of England's borrowing and savings calculator to see the effects of different rates of interest on your savings or borrowing. If you're reading a printed copy of this article, you can use the underlined phrase to search the Internet to find the calculator.

What can you do?

Consider investing any cash that you don't need in the short term (in the next five years) to increase the chance that your money will grow and keep pace with the rate of inflation. It's true that investing your money is riskier than leaving it in cash-based savings, as you could lose some or all of your money. But there is also the risk your cash-based savings could be eroded by inflation. Over the medium to long term (anywhere between five and ten years) returns from investing should be better than cash-based savings, although this isn't guaranteed.



What's next?

Contact your financial adviser today. They have the knowledge and expertise to help you choose the investment options that are right for you.

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