

Understanding inflation

The inflation rate is calculated from the prices of a range of different goods and services selected to represent average spending patterns in the UK. The Office for National Statistics monitors changes in these prices each month, and uses this to work out an average increase for the year. The different items in the 'basket' of goods and services are given different weights, so that things we spend more on, like housing, motoring and food, are given more importance.

Changing spending patterns

The ONS updates which goods and services it collects prices on each year, and what weight it gives them, in line with general spending patterns. The most recent review, for example, effective from February 2002, brought in DVD players, women's hair colourant, frozen vegetarian ready meals and cable telephone charges, but took out loose tea, pipe tobacco, shower curtains and credit card charges. In February 2001, organic fruit and vegetables and gym membership came in, while salad cream and women's ski pants went out.

The pie chart shows the weight given to different components in the RPI out of a total of 1,000, based on how much an 'average person' spends on them. From February 2002, more weight has been given to wines and spirits and the purchase of motor vehicles, and less to mortgage interest payments and petrol and oil, reflecting their lower price.

Latest inflation

The latest inflation rate shows prices increasing by 1.0 per cent in the year to February 2002. Within this, prices for clothing and footwear fell by 5.3 per cent on the year, including a fall of 10 per cent in prices for women's 'outerwear'. Prices for leisure goods are also falling, by 1.9 per cent in the year to February. In this category, the cost of audio-visual equipment fell by 11 per cent on the year, with average prices at one third of the level they were at in January of 1987. The cost of motoring is also lower than a year ago. While it costs more now to maintain a vehicle, the price of petrol has fallen over the last 12 months (from 77p to 71p for a litre of unleaded petrol).

Housing costs are also lower now than they were a year ago, by 1.4 per cent. While the retail price index does not include the costs of buying a house (because this is considered an investment), it does include the costs of mortgage interest payments (the interest-only component of mortgage repayments). There is also a depreciation component, which measures the cost to owner-occupiers of maintaining their house at a constant quality, such as occasional renovation. This varies with house prices.

Highest inflation rates, February 2002

	Percentage of January 1987 level
Cigarettes	295.6
Personal services (eg hairdressing)	292.2
Entertainment and other recreation	274.3
Vehicle tax and insurance	270.0
Water and other charges	268.9
Rent	248.8
Repairs and maintenance charges	245.0
Tobacco	232.0
Domestic services (eg cleaning)	230.8
Maintenance of motor vehicles	228.4

Items pushing the inflation rate up include leisure services, the average prices for which have risen by 6.7 per cent on the year. Within this, the costs of television licences and rentals have increased by 16 per cent over the last 12 months. The price of tobacco products has risen by 3.3 per cent on the year but, due to the impact of tax increases, this is the area which has seen the highest long-term growth in prices. Cigarettes are now three times as expensive as they were 15 years ago (while the average price of all goods and services has risen by 74 per cent).

RPI and RPIX

The outline above refers to the all-items Retail Prices Index (RPI). The Government's target measure of

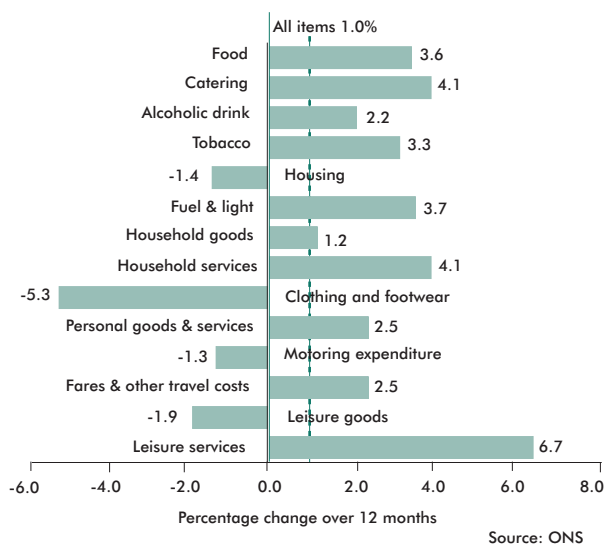
Lowest inflation rates, February 2002

	Percentage of January 1987 level
Audio-visual equipment	32.8
Women's outerwear	78.3
Electrical appliances	89.3
Telephones, telemessages etc	90.3
Children's outerwear	101.2
Men's outerwear	103.2
Toys, photographic and sports equipment	107.1
CDs and tapes	109.5
Poultry	109.6
Coffee and other hot drinks	115.9

inflation, however, is the RPIX, for which the Bank of England has a long-term target of 2.5 per cent. There is one difference between the two measures: the RPIX excludes mortgage interest payments. The reason for this is that the Bank of England uses interest rates to try to control inflation. It puts them up to increase the cost of borrowing, and therefore reduce spending in the economy, to bring down inflation. If the target measure was the all-items RPI, putting up interest rates would also directly push up inflation, through the inclusion of mortgage interest payments, which go up and down with the level of interest rates. So the impact of monetary policy would be harder to detect.

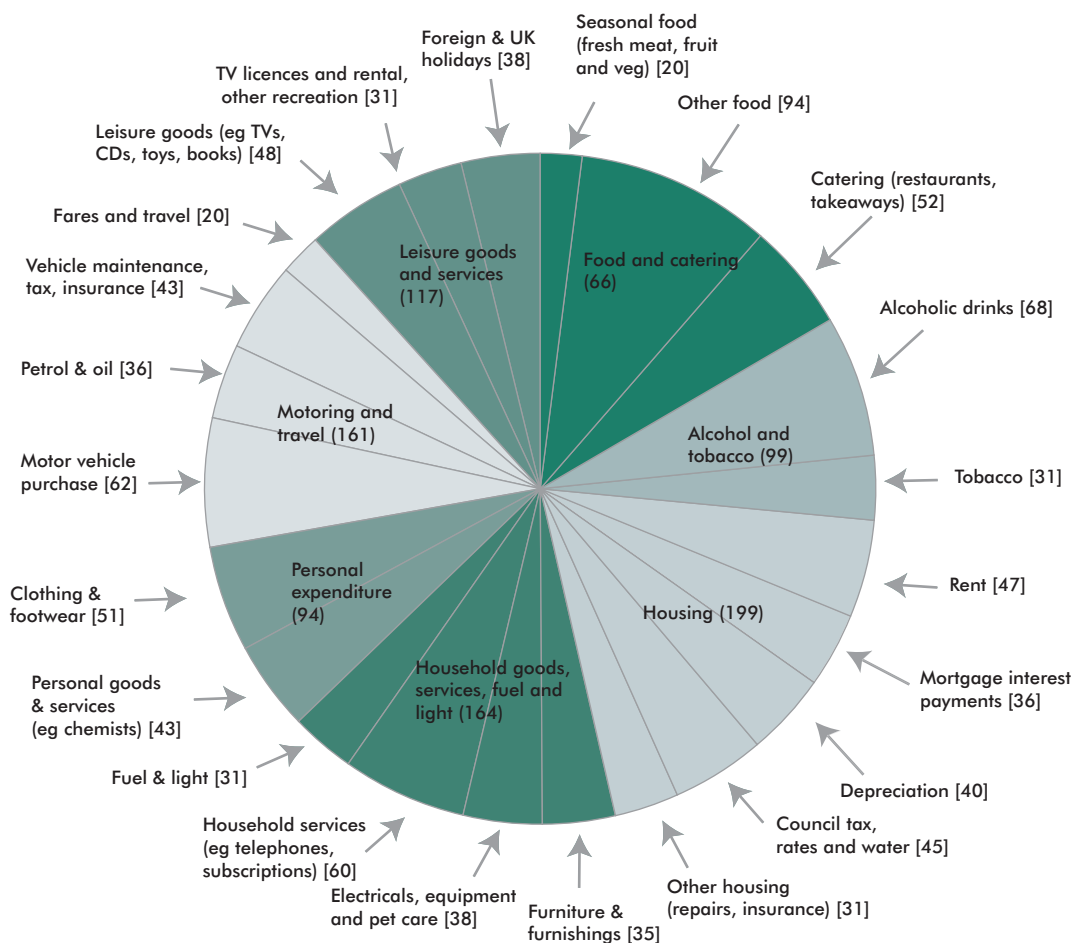
The exclusion of mortgage interest payments from the RPIX means that it is lower than the all-items RPI when interest rates have been rising over the previous year, and higher than the all-items rate when interest rates have been falling, as at the moment, with RPIX at 2.2 per cent. Until recently, the all-items RPI was by far the most common measure used in pay negotiations. But given the very

RPI comparison of 12-month percentage changes



low level of the all-items measure in the last few months, more people have started to look at the RPIX as a basis for wage bargaining.

Components of the retail prices index



Note: The figures in brackets represent the weights out of 1,000