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Beat the savings squeeze as rates stay low

In the first of our five-part guide, Kate Hughes offers tips on how to rebuild finances battered by the recession

MILLIONS of savers face a dilemma as uncertainty over interest rates forces them to choose between fixing now and gambling on future rises.

Last week, the Centre for Economics and Business Research said interest rates would be at the record low of 0.5% until at least 2011 and would not rise above 2% until after 2014.

Meanwhile, inflation fell farther than expected from 1.6% in August to 1.1% in September, its lowest rate in five years on the consumer prices index (CPI) — the government's preferred inflation measure. The retail prices index (RPI), which includes mortgage interest payments, fell to –1.4% from –1.3% in August.

This may be welcome news for borrowers, but for savers, including pensioners living off interest payments, the struggle for decent returns continues — at least for the time being.

Trevor Williams, chief economist for Lloyds TSB Corporate Markets, said: "The CPI is likely to remain at 1% for several months. As economic recovery resumes and the effects of a rise in Vat come through, it is likely inflation will rise gradually. However, based on the economic profile, a long period of low UK inflation lies ahead."

However, markets seem to be more worried about inflation than economists — for example, gold, a traditional hedge against inflation, has soared to record highs above $1,050.

Chris Huelin of Collins Stewart Wealth Management, said: "With economic indicators showing positive signs and policymakers likely to err on the side of caution by leaving interest rates lower for longer, we now expect a return to sustained growth with inflation rates much higher than consensus expectations."

So, should savers lock in to today's high rates of 5% or wait to see if they rise further?

Fixed-rates savings accounts could go up even if Bank rate remains on hold because they are generally priced according to expectations in the wholesale money markets.

Some 9m consumers have locked away £131 billion in fixed-rate savings accounts in the past 12 months — each investing an average of £14,237, said uswitch.com, the comparison site. However, 6% of those already regret their decision — 1m have withdrawn money and 1.7m think they will have to access their cash before the end of the term.

Here we offer a guide to rebuilding your savings in the wake of the credit crunch without getting caught out later when interest rates rise.

1 FIX — BUT NOT FOR LONG Instant or easy-access accounts currently offer an average rate of only 0.91% on balances up to £1,000. Alternatively you could fix at the current best-buy of 5.3% for five years with Yorkshire building society. On savings of £10,000, that would mean extra interest of £439 a year before tax.

However, a shorter-term fix may offer an attractive alternative for those who might need access to the money, or who feel more significant increases in rates will kick in soon.

David Black at Defaqto, the financial data firm, said: "If you lock in your money for just three years, you can still achieve a rate of 4.7% with Barnsley building society's 3-year online bond. Even over two years, the AA, through Birmingham Midshires, has the best buy at 4.35% with its internet 2 -year fixed. This is a guessing game, but fixing for only a few years is unlikely to mean missing out."

Over 12 months, the advantages of fixed over instant-access accounts are far less clear. The best rate on the market is from Saga at 3.75% and only for savers over 50 years old. The West Bromwich branch bonus account offers a similar rate with instant access, albeit with an introductory bonus of 1% for the first year.

Rumina Hassam at Uswitch said: “Almost half of all fixed-rate accounts do not allow consumers to access their cash under any circumstances which, in a climate of recession and redundancy, can be dangerous. Even if consumers are allowed to make withdrawals, the extra interest earned could be wiped out by the penalties.”

2 WORK BONUSES An introductory bonus can see an otherwise mediocre offer soaring to the top of the best-buy tables. Black said: “Take advantage of them, but prepare to jump ship as soon as the bonus ends.”

The headline rate for the AA’s internet extra easy access account, for example, is 3.15% for balances up to £50,000, but this is largely made up of an introductory bonus rate at 2.65%. Investing £10,000 here will earn £315 in the first year, but just £51 in the second.

3 SPREAD YOUR BETS Peter Chadborn at CBK Colchester, a financial adviser, said: “Dividing your cash could be the right answer for savers who want a piece of every pie. ”

Splitting £10,000 equally between today’s best-buy instant-access account of 3.70% from West Bromwich and five-year fix of 5.3% would give you interest of £187.50 and £265 respectively — a total of £452.50 in one year — compared with £530 if you put it all in the fix — a small price to have access to more than £5,000.

Remember, the Financial Services Compensation Scheme will protect savings deposits up to £50,000 per saver for each institution.

4 MAKE THE MOST OF ISAS Lloyds TSB, RBS, NatWest and Norwich & Peterborough building society have slashed rates across their ranges by an average 0.25 percentage points — just in time for the increase in the cash Isa allowance for the over-fifties from £3,600 to £5,100 this month.

ING Direct has already dropped the rate for existing customers on its cash Isa from 3% at the beginning of the tax year to 2.5% last week.

Chadborn said: “A lot of money lies dormant in Isa accounts so check the rate older cash Isas are paying every six months.”

First Direct’s instant access e-Isa pays 3%, allows transfers, and imposes no penalties. Barnsley building society’s instant access online Isa also permits transfers and penalty-free withdrawals at 2.65%, or 3.04% for balances of £20,000 or more. Both rates include a introductory bonus of 0.75%.

5 PREMIUM BONDS MAKE COMEBACK Investors are increasingly turning to National Savings & Investments premium bonds. These have historically been uncompetitive, but with interest rates expected to stay lower for longer, some advisers suggest they are worth a look.

Tim Whiting, managing director of Timothy James & Partners, the adviser, has been recommending his wealthy clients buy up as many as possible. The premium bond prize fund is calculated using an interest rate of 1.5% — so more than the average instant-access account — and prizes are tax free, meaning higher-rate taxpayers are effectively getting 2.5% with instant access and government security.

For traditional savings, the High 5 account from Investec pays 3.37% and promises to pay the average of the top five rates on the market, removing the need to worry about switching.

What September inflation means for pensioners

THE news that inflation has slumped to a five-year low has wider implications than the cost of groceries or whether you will be able to successfully negotiate that pay increase.

For millions of people who rely on benefits and the state pension, the data is vital for their income.

Although state pensions are calculated with reference to September inflation numbers, an outcry against an increase of just 75p in 2000 now means payments will always rise by 2.5% or the rate of inflation — whichever is higher.

The basic state pension will therefore increase in 2010 by £2.40 to £97.65 a week or by £3.85 to £156.15 for couples. Meanwhile, people qualifying for child benefit and the working tax credit do not have that default 2.5% rate of increase next year. There will be no change in these payments in 2010 because they rise in line with the September figure or nothing, whichever is higher.