CPI Review submission

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– As one of only two OECD nations to produce a quarterly CPI, the ABS is likely to receive a number of submissions proposing the move to monthly data. Any such move needs to ensure a (continued) high level of reliability and accuracy of the CPI data, with the appropriate increase in resources. Revision of past data needs to be avoided!
– Any potential move to a monthly CPI may also require some guidance from the ABS on the best method of adjustment for the many contracts and economic activities that rely on the CPI to adjust prices, incomes and taxes.
– The ABS will also need to make an assessment on whether the volatility in the 'deposit and loan facilities' index is a temporary function of the financial crisis, or if there is more entrenched difficulties with its calculation.
– More frequent updates of the weights within the CPI (rather than the current 6 years) may be needed to ensure a more accurate reflection of rapidly changing spending patterns in terms of the number of goods and services that can be purchased over the internet and to better reflect Australia's changing demographics.
– The ABS should consider publication of the broad range of 'underlying' CPI measures the RBA now seems to be using. The publication of the 'core ex-food and energy CPI' would also aid in international comparison.
– The ABS will likely also need to consider providing data on the price of carbon in the future and how this price impacts on other prices in the economy, such as for electricity and other sources of energy.

Introduction:
The following is a submission from the Investment Markets Research team (author details are on page 5) from Colonial First State Global Asset Management to the Australian Bureau of Statistics (ABS) review of the Consumer Price Index (CPI) – the 16th Review.

This submission will run through the major issues identified by the ABS in relation to the CPI and, where applicable, offer our views and comments on how the CPI can be improved to match the needs of the economy as a whole and decision-makers who use the CPI information.

1. Principal purpose of the CPI:
As noted by the ABS, since the 13th Review in 1997, the CPI has been based on the ‘acquisitions’ approach to compiling the CPI, measuring the change in the price of goods and services purchased by households. We have no comment on this approach, except to note that there seems to be a wide level of support for the current arrangements.

2. Complication frequency of the CPI:
As noted by the ABS, currently there are only two countries in the OECD that publish quarterly CPI, as opposed to monthly, Australia and New Zealand. It is clear, therefore, that Australia’s quarterly CPI stands out as a laggard against more frequent data from other major OECD nations and also stands out against more timely monthly economic data for other major economic information – such as employment, retail sales, housing finance, building approvals etc.

The arguments for a monthly CPI could include:

- A monthly CPI would bring Australia more in-line with international best practice. This could be seen as an important development for Australia, helping to reinforce the view that Australia’s economic performance is well placed within the OECD region.
- A monthly CPI would clearly provide more data on inflation trends, allowing users of the CPI (including both the financial markets and the Reserve Bank of Australia) to more quickly pick up on any potential change in trends that could be significant for policy and financial market developments.
- A monthly CPI could have the potential of smoothing financial market and economic decision maker’s reactions to inflation news. As opposed to a quarterly CPI release, which can have significant impacts on financial market pricing, a monthly CPI is likely to smooth out any financial market developments over the cycle.
- A monthly CPI could also help anchor inflation expectations. By providing more frequent data points it could be easier to limit concerns about a significant change in trend for inflation, by providing earlier warning and/or confirmation of changing developments in price setting.

In contrast, some arguments against a monthly CPI could include:

- A monthly CPI could lead to greater volatility in financial markets, especially if one month in a normal quarterly cycle was to print a “rogue” number that would have been averaged out of a quarterly calculation.
- The current monthly inflation gauge published by TD Securities and the Melbourne Institute does not have a significant impact on market pricing and can provide some misleading signals with monthly volatility – suggesting no great desire by the markets for monthly inflation data.
- The quarterly CPI release has served Australia very well, especially in terms of the RBA’s 2%-3% inflation target, which has been achieved very successfully.
- The introduction of a monthly CPI would likely add significantly to the costs of producing the CPI. While around half of all goods and services are currently priced monthly, this still leaves half of the CPI basket with less frequent pricing. This would obviously need to change and would likely incur a significant cost increase.
- For the ABS the key issue is whether this higher cost could be covered by increased funding from the government or whether cost savings would need to be found in other areas of the ABS.
- With less time to prepare each data set, any move to a monthly CPI could bring with it the risks of errors in calculation and the subsequent need for revisions to data. This would be a concern, considering the importance of the CPI to economic and policy decision makers. The ABS would need to be very confident that they could produce a monthly CPI with the same level of accuracy as the current quarterly publication. Revisions of CPI data cannot be undertaken.
- The ABS would also need to ensure that they could produce the monthly CPI with the same level of breakdown of information (ie. by State and by Index grouping) as is currently detailed in the quarterly CPI release.
- Another issue in any potential move to a monthly CPI is the significant impact this could have on contracts, financial and legal arrangements that are currently linked to the quarterly CPI. See “other issues” below for further details.

Balancing these arguments would tend to support a move to a monthly CPI, but the case is by no means clear-cut. If the rest of the OECD can compile an accurate and timely monthly inflation reading, then the ABS should also be able to do so (especially given the high standing the ABS holds in global markets). For economic and financial market decision makers, more information is likely to be always better than less frequent data, as long as the accuracy of the information can be retained.

3. Evaluation of the deposit and loan index:

The 'deposit and loan facilities index' is an important part of the CPI, measuring the cost of financial services in Australia. While it seems sensible to retain within the CPI a measure of the cost of financial services, the volatility of this sub-component over recent years (ie. especially during the global financial crisis) is a cause of concern, as is the seeming relationship with the level of interest rates.

The question the ABS needs to answer is whether the volatility and large increase in this sub-component is just a function of the increase in bank lending margins over the cash rate that has flowed from the effects of the GFC or whether there is a longer-term statistical problem with the sub-index. If the expectation is that this sub-index will settle down once bank lending margins also settle down, then the current form of the sub-index could be retained. If not, then an alternative measure of the cost of financial services may need to be developed.

4. Maintaining the relevance of the CPI:

To maintain the relevance of the CPI to the economy and decision makers it needs to accurately reflect the spending patterns of Australian households. Currently this is partly done via the Household Expenditure Survey (HES), but this survey is conducted only every six years.

Given the speed of advances in information and communications technology, it could be argued that an adjustment every six years is too infrequent. A clear example here is likely to be the extent of internet goods shopping (eg. books, groceries, music), which could be expected to change significantly over any given six year period. In addition, it is likely that purchases of services over the internet (eg. banking and insurance) will continue to increase rapidly and a six year period between adjustments could be too long.

In this regard, therefore, it could be advantageous for the ABS to have more regular updates of the weights (say every 2-3 years) for goods and services that can be purchased electronically.

In addition, Australia's current rapid population growth is also likely to require more frequent updates than every six years. Given that Australia's high population growth rate is being driven largely by strong immigration inflows, the changes to Australia's demographics and spending patterns that this implies could mean the need for more regular updates to the spending patterns of Australian households.

5. Commodity classification

The focus here for the ABS needs to remain on ensuring the most accurate commodity classification and relevance of commodity grouping is maintained.

6. Analytical series

Apart from the Headline CPI, the ABS currently also publishes a number of "analytical series" for inflation, including the Trimmed Mean and Weighted Median has used and highlighted by the Reserve Bank of Australia. Recently however (see "The Current Economic Landscape", Philip Lowe, Assistant Governor (Economic), 18 February 2010) the RBA looks like it is broadening its definition of Underlying inflation to include a Trimmed Mean annual distribution, Weighted Median city based and an Exclusion measure. While no details of the construction of these Underlying inflation measures were provided in the quoted speech, it would be desirable for the ABS to publish this data if they are to form part of the RBA's thinking on inflation.

In addition to the RBA Underlying inflation measures, the ABS should also give consideration to publishing a "ex food and energy" inflation index. In many other OECD nations, ie. especially the US, the ex food and energy CPI is commonly referred to as Core inflation. While this series may have some drawbacks, the publication of this measure of Core inflation by the ABS would provide a useful and robust means of comparison in terms of inflation in Australia versus our OECD peers.

7. Other issues:

a) The current quarterly release of the CPI is used extensively in the Australian economy to adjust prices, taxes and contracts for a large number of commercial sectors of the economy. This includes government payments, government taxes, utility charges, toll charges and coupon payments for inflation index linked bonds issued by the Commonwealth and States.

   If the ABS was to move to a monthly CPI, the question then arises as to what index would then be used for all the contracts and economic relationships that are currently adjusted by the quarterly CPI. For example, if a contract is currently adjusted by the March qtr CPI, would it then be adjusted by the middle months of the quarter, ie.

February, or an average of the three monthly numbers for January, February and March, or just for the month or March?

A resolution to this issue and some guidance from the ABS would likely be a very important part of the process of moving to a monthly CPI – if this was to occur.

b) Another important issue for the ABS to consider is the timeliness of the release of the CPI, especially if there was a move to monthly data. Currently, the ABS releases the CPI around 6-7 weeks after the end of the quarter. International best practice seems to be around 3-4 weeks after the end of each month for the monthly CPI release (ie. US, Japan and Canada are 3 weeks, while the major European nations are around 4-6 weeks).

To bring Australia into line with international best practice, especially in the context of the central role of inflation targeting played by the RBA and the need for timely data to continue to support Australia's need for global capital inflow, a shortening of the period between the end of each relevant period and the data release looks like it would be a worthwhile goal.

c) Another issue for the ABS to consider in the future is the pricing of carbon. While there is still significant political uncertainty over what form Australia's approach to carbon reduction will take, there is a good change that a price will be set for carbon in the future and that this price will be actively traded on markets.

Market efficiency and liquidity is likely to be aided if the ABS acts as the independent provider of key price data for carbon and the impact this price has on other prices in the economy (ie. for electricity, aluminium etc).

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