J.P.Morgan

Economic Research

J.P. Morgan Securities Inc.
March 11, 2010

Issues to be considered during the 16th Series Australian Consumer Price Index Review

Purpose of this submission

The Australian Bureau of Statistics (ABS) currently is undertaking a review of its Consumer Price Index (CPI). The ABS is seeking feedback from users of the CPI to inform the review and provide an opportunity for user involvement in the evolution of the CPI.

J.P. Morgan believes the issues below deserve consideration

1. Principal purpose of the CPI

We agree that measuring inflation faced by households should remain the principal purpose of the CPI. The acquisitions approach is the most appropriate as it only includes the change in prices of the goods and services acquired by households (actual prices and market determined prices). This measure of price inflation is the more encompassing (and less volatile) measure of broad price pressures faced by households, in contrast to either the outlays approach or the cost-of-use approach.

The three measures tend to produce similar outcomes over the longer-term, but can diverge significantly in the short-term. The short-term outcome is key in assessing the current inflationary environment and is crucial in determining monetary policy settings. The RBA supports an acquisitions approach, as highlighted in the 13th series CPI review. Indeed, the RBA acknowledged in its semi-annual Statement on Monetary Policy in November 1998 that the ABS' decision to implement changes to the calculation of the CPI, by adopting the acquisitions approach around that time, would "significantly" reduce the problems in using the published CPI to evaluate the stance of monetary policy.

From the September quarter 1998, the compilation of the CPI was changed to remove the interest charges component, replacing it with an alternative means of estimating housing costs. It was only then that the RBA indicated that the inflation target could be seen as applying to the published CPI.

The certifying analyst(s) is indicated by the notation "AC." See last page of the report for analyst certification and important legal and regulatory disclosures.

2. Compilation frequency of the CPI

We believe the case for increasing the frequency of the CPI is strong, providing the monthly series is sufficiently accurate and the quality of the data remains intact, and notwithstanding our comments on the likely impact of seasonality on the Australian inflation-linked bond market. A monthly series potentially will allow for earlier detection of turning points in inflation and, in turn, changes to monetary policy expectations.

We acknowledge that the costs of replicating the CPI on a monthly basis would be significant given that, at present, only half of the products in the CPI are priced monthly, but greater frequency would help identify changes in inflation more quickly. With respect to monetary policy, this would provide more timely information on price pressures to the RBA. The RBA then would be less likely to be restricted to quarterly moves in the cash rate – in 2007, for example, the RBA only moved the cash rate following the 2Q07, 3Q07, and 4Q07 inflation reports.

The monthly compilation of CPI appears to be a global standard, so in moving to a monthly frequency the ABS would allow for better international comparisons of inflation. As highlighted in the information paper, Australia is one of only two countries that do not provide the monthly CPI data. The IMF even specifies that member countries should produce monthly CPIs, but allows for flexibility to ensure that it is appropriate to individual countries.

The interest generated by TD Securities monthly inflation gauge suggests that demand for a monthly CPI series exists. The TD monthly inflation gauge acts as a timely, but imperfect, indicator of inflation, and is released on the Monday prior to the RBA's Tuesday policy meetings. It, therefore, may be considered in RBA deliberations. It would be preferable to have an official monthly inflation measure released by the ABS.

3. Evaluation of the deposit and loan facilities index

We welcomed the inclusion of the deposit and loan facilities component of the CPI back in 2005. It provides a useful gauge of the cost to consumers of banking services, but seems to have contributed to increased volatility in the data. It has become increasing difficult to forecast quarterly changes in this index since the global financial crisis. We believe the ABS should be more transparent in the calculation of this component. The ABS has outlined in broad terms how they construct the deposit and loan facilities index, but should consider publishing even more information on the inputs used to calculate the index in each release. It would be useful to know, for example, what interest rate margins the ABS is using to calculate the change in this component. In particular, the ABS should consider publishing the borrowing and lending rate series used to construct the reference rate and, therefore, the spread. This would allow greater transparency in observing how changes in interest rates and balances affect the spread.

As we indicate later in this submission, any change to either the compilation and/or transparency of

the ABS' calculations needs to be assessed against the potential impact of pricing in the inflation linked bond market.

4. Analytical series

We believe there is a need for a seasonally adjusted CPI in addition to an unadjusted headline print. Additionally, it would be useful for the ABS to publish a CPI series excluding food and energy, which is the common 'core' measure referred to in most OECD counties. Yes, we can calculate this measure ourselves, but it would be preferable for the ABS to publish it in each CPI release. Financial markets and the public need a centrally agreed upon set of measures to be endorsed by the ABS. Clearly, statisticians in other countries do not believe that the cost of producing monthly series is prohibitive.

5. Inflation markets

(i) Nominal Interest Rate Markets

Economic data have an important influence on interest rate markets. Theoretically, nominal government bonds reflect the risk free yield curve in any market; that is, there is no premium for credit risk. Government bond yields should, therefore, reflect expectations for growth and inflation over the time horizon of the bond's maturity. So changes in expectations about the path of real GDP growth and the path of inflation over the lifetime of a government bond should, theoretically speaking, affect the level of yields.

So it should come as no surprise that the quarterly inflation release is one of the most keenly anticipated economic releases in the Australian bond market. In reality, the transmission mechanism between inflation data and the level of government bond yields (particularly those for government bonds 3-years or lower in maturity) is not as pure as we describe above. The immediate transmission mechanism between inflation data and bond yields in the short-term has to do with monetary policy expectations.

A higher than expected inflation number (relative to market economists' expectations) usually increases expectations that the RBA may respond with a higher policy rate at some point (given the RBA is an inflation targeting central bank). For shorter dated government bonds, expectations of a higher policy rate ricochets further out the yield curve (for example, one can think of a 3-year bond as three 1-year bonds) and drives yields higher. The reverse dynamic can apply if the inflation data print on the weaker side of expectations. It is also worth noting that the government bond curve, as the risk free curve, is the anchor for yields on most other interest rate products. So a move in government bond markets is usually replicated across other interest rate markets (such as swap, semi-government bond, supranational bond, and corporate bond markets).

In a broad sense, the path of 3-year bond yields is largely dependent upon monetary policy and monetary policy expectations. It is largely because the market sees a high informational value in the inflation numbers (or more precisely, the deviation of the inflation numbers from consensus) for near term monetary policy activity that gives the inflation data potential to drive reasonably significant intraday moves in yields. From a trading bank perspective, the potential for intraday volatility should be regarded as a positive outcome.

(ii) Inflation linked interest rate markets

Inflation linked bonds and swaps offer investors and other market participants the ability to hedge inflation risk. For example, utilities, infrastructure and real estate projects could be described as “suppliers” of inflation (their businesses tend to do better in high inflation environment). On the other side, pension funds have a “demand” for inflation (high inflation environments are not desirable). As inflation linked markets have deepened, inflation linked interest rate products also offer investors the chance to add alpha to their portfolios through relative value and other such trading strategies.

We think the ABS should be aware that the inflation linked bond market in Australia has recently undergone something of resurgence. Issuance was suspended in 2003, but resumed last year with an A$2 billion syndicated deal for a new 2025 maturity bond in 2009. Furthermore, the removal of withholding tax of government bonds has seen considerable interest in this market from offshore investors. In our view, it would be undesirable to implement changes to the headline CPI series which might deter investor interest and the further development of the A$ inflation linked market. Inflation linked interest rate markets are explicitly tied to the ABS measure of headline inflation; this is because the headline CPI index is used to determine the price of an inflation linked bond (and the coupon payments) at any given time. Theoretically, changing the periodicity of the inflation release should not have a material impact on inflation bond and swap markets. This is because coupons and pricing would still be able to use any quarterly change in the index, regardless of whether the index is published quarterly or monthly. However, for holders of inflation linked stock, monthly inflation numbers imply the potential for more volatility in the cost of carry (there is more chance of monthly negative inflation number than a negative quarterly inflation number). This dynamic may be exacerbated if there is higher inherent seasonality in the monthly inflation series than the quarterly inflation series. This, though, should not be viewed as sufficiently high to preclude the publication of monthly CPI data, which we strongly support.

Changing the composition of inflation indices can have significant impacts on inflation linked interest rate markets. It is probably worth noting the experience of Japan in 2005, where rebasing the index and altering some of the weights and method of calculation of prices (particularly in the telecommunications sector) led to lower indices and lower changes over the year on the 2005 base than those calculated on the 2000 base. This led to an immediate 30bp decline in 10-year breakeven rates (a loss for holders of inflation linked bonds). With the CPI review focusing on compilation of the deposit and loan facilities, we think any changes to this component should be communicated well in advance in order to help predict any significant change in the revision in order to minimize

the "surprise" to the market.

As a final aside, we note that the Australian Treasurer, Australian Office of Financial Management and RBA have a vested interest in any change to coverage, periodicity, or basic calculation of the CPI. This is because if the Treasurer deems any change in the CPI as "materially detrimental to the interest of stockholders", then bond holders will have the option to redeem their holdings at market related prices as determined by the RBA. For more information, please see go to: http://www.aofm.gov.au/content/_download/Treasury_Indexed_Bond_Information_Memo_18_December_2009.pdf)

Analyst Certification: The analyst(s) denoted by an asterisk ("AC") hereby certifies that: 1) all of the views expressed in this research accurately reflect his or her personal views about any and all of the subject securities or issuers; and 2) no part of any of the analysts compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the analyst(s) in this research.

Conflict of Interest: This research contains the views, opinions and recommendations of JPMorgan credit research analysts. Research analysts routinely consult with JPMorgan trading desk personnel in formulating views, opinions and recommendations in preparing research. Trading desks may trade, or have traded, as principal on the basis of the research analyst(s) views and report(s). Therefore, this research may not be independent from the proprietary interests of JPMorgan trading desks which may conflict with your interests. In addition, research analysts receive compensation based, in part, on the quality and accuracy of their analysis, client feedback, trading desk and firm revenues and competitive factors. As a general matter, JPMorgan and/or its affiliates normally make a market and trade as principal in fixed income securities discussed in research reports.

Analysts'Compensation: The research analysts responsible for the preparation of this report receive compensation based upon various factors, including the quality and accuracy of research, client feedback, competitive factors and overall firm revenues. The firm's overall revenues include revenues from its investment banking and fixed income business units.

Explanation of Credit Research Ratings

Ratings System: JPMorgan uses the following sector/issuer portfolio weightings: Overweight (over the next three months, the recommended risk position is expected to outperform the relevant index, sector, orbenchmark), Neutral (over the next three months, the recommended risk position is expected to perform in line with the relevant index, sector, or benchmark), and Underweight (over the next three months, the recommended risk position is expected to underperform the relevant index, sector, or benchmark). JPMorgan uses the following fundamental credit recommendations: Improving (the issuer's credit profile/credit rating likely improves over the next six to twelve months), Stable (the issuer's long-term credit profile/credit rating likely remains the same over the next six to twelve months), Deteriorating (the issuer's long-term credit profile/credit rating likely falls over the next six to twelve months), Defaulting (there is some likelihood that the issuer defaults over the next six to twelve months). JPMorgan's Emerging Market research uses a rating of Marketweight, which is equivalent to a Neutral rating.

Valuation & Methodology: In JPMorgan's credit research, we assign a rating to each issuer (Overweight, Underweight or Neutral) based on our credit view of the issuer and the relative value of its securities, taking into account the ratings assigned to the issuer by credit rating agencies and the market prices for the issuer's securities. Our credit view of an issuer is based upon our opinion as to whether the issuer will be able service its debt obligations when they become due and payable. We assess this by analyzing, among other things, the issuer's credit position using standard credit ratios such as cash flow to debt and fixed charge coverage (including and excluding capital investment). We also analyze the issuer's ability to generate cash flow by reviewing standard operational measures for comparable companies in the sector, such as revenue and earnings growth rates, margins, and the composition of the issuer's balance sheet relative to the operational leverage in its business.

Planned Frequency of Updates: JPMorgan provides periodic updates on companies/industries based on company-specific developments or announcements, market conditions or any other publicly available information.

JPMorgan Credit Research Ratings Distribution, as of July 3, 2006

	Overweight	Neutral	Underweight
EMEACredit Research Universe	27%	49%	25%
IB clients*	57%	62%	62%

Represents Ratings on the most liquid bond or 5-year CDS for all companies under coverage.

* Percentage of investment banking clients in each rating category.

Options related research: If the information contained herein regards options related research, such information is available only to persons who have received the proper option risk disclosure documents. For a copy of the Option ClearingCorporation's Characteristics and Risks of Standardized Options, please contact your JPMorgan Representative or visit the OCC's website at http://www.optionsclearing.com/publications/risks/riskstoc.pdf.

Legal Entities: JPMorgan is the marketing name for JPMorgan Chase & Co. and its subsidiaries and affiliates worldwide. J.P. Morgan Securities Inc. is a member of NYSE and SIPC. JPMorgan Chase Bank, N.A. is a member of FDIC and is authorized and regulated in the UK by the Financial Services Authority. J.P. Morgan Futures Inc., is a member of the NFA. J.P. Morgan Securities Ltd. (JPMSL) is a member of the London Stock Exchange and is authorized and regulated by the Financial Services Authority. J.P. Morgan Equities Limited is a member of the Johannesburg Securities Exchange and is regulated by the FSB. J.P. Morgan Securities (Asia Pacific) Limited (CE number AAJ321) is regulated by the Hong Kong Monetary Authority. JPMorgan Chase Bank, Singapore branch is regulated by the Monetary Authority of Singapore. J.P. Morgan Securities Asia Private Limited is regulated by the MAS and the Financial Services Agency in Japan. J.P. Morgan Australia Limited (ABN 52 002 888 011/AFS Licence No: 238188) (JPMAL) is regulated by ASIC.

Legal Entities Disclosures

U.S.: JPMSI is a member of NYSE, NASD and SIPC. J.P. Morgan Futures Inc. is a member of the NFA. J.P. Morgan Chase Bank, N.A. is a member of FDIC and is authorized and regulated in the UK by the Financial Services Authority. U.K.:J.P. Morgan Securities Ltd. (JPMSL) is a member of the London Stock Exchange and is authorized and regulated by the Financial Services Authority. **South Africa:** J.P. Morgan Equities Limited is a member of the Johannesburg Securities Exchange and is regulated by the FSB. **Hong Kong:** J.P. Morgan Securities (Asia Pacific) Limited (CE number AAJ321) is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission in Hong Kong. **Korea:** J.P. Morgan Securities (Far East) Ltd, Seoul branch, is regulated by the Korea Financial Supervisory Service. **Australia:** J.P. Morgan Australia Limited (ABN 52 002 888 011/AFS Licence No: 238188)is regulated by ASIC and J.P. Morgan Securities Australia Limited (ABN 61 003 245 234/AFS Licence No: 238066) is a Market Participant with the ASX and regulated by ASIC. **New Zealand:** J.P. Morgan Securities New Zealand Limited is a New Zealand Exchange Limited Market Participant. **Taiwan:** J.P.Morgan Securities (Taiwan) Limited is a participant of the Taiwan Stock Exchange (company-type) and regulated by the Taiwan Securities and Futures Commission. **India:** J.P. Morgan India Private Limited is a member of the National Stock Exchange of India Limited and The Stock Exchange, Mumbai and is regulated by the Securities and Exchange Board of India. Thailand: JPMorgan Securities (Thailand) Limited is a member of the Stock Exchange of Thailand and is regulated by the Ministry of Finance and the Securities and Exchange Commission. **Indonesia:** PTJ.P. Morgan Securities Indonesia is a member of the Jakarta Stock Exchange and Surabaya Stock Exchange and is regulated by the BAPEPAM. Philippines: This report is distributed in the Philippines by J.P. Morgan Securities Philippines, Inc. **Brazil:** Banco J.P. Morgan S.A. isregulated by the Comissao de Valores Mobiliarios (CVM) and by the Central Bank of Brazil. Japan: This material is distributed in Japan by JPMorgan Securities Japan Co., Ltd., which is regulated by the Japan Financial Services Agency (FSA). **Singapore:** This material is issued and distributed in Singapore by J.P. Morgan Securities Singapore Private Limited (JPMSS) [mica (p) 069/09/2006 and Co. Reg. No.: 199405335R] which is a member of the Singapore Exchange Securities Trading Limited and is regulated by the Monetary Authority of Singapore (MAS) and/or JPMorgan Chase Bank, N.A., Singapore branch (JPMCB Singapore) which is regulated by the MAS. **Malaysia:** This material is issued and distributed in Malaysia by JPMorgan Securities (Malaysia) Sdn Bhd (18146-x), which is a Participating Organization of Bursa Malaysia Securities Bhd and is licensed as a dealer by the Securities Commission in Malaysia.

Country and Region Specific Disclosures

U.K. and European Economic Area (EEA): Issued and approved for distribution in the U.K. and the EEA by JPMSL. Investment research issued by JPMSL has been prepared in accordance with JPMSL's Policies for Managing Conflicts of Interest in Connection with Investment Research which can be found at http://www.jpmorgan.com/pdfdoc/research/ConflictManagementPolicy.pdf. This report has been issued in the U.K. only to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (all such persons being referred to as "relevant persons"). This document must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is only available to relevant persons and will be engaged in only with relevant persons. In other EEA countries, the report has been issued to persons regarded as professional investors (or equivalent) in their home jurisdiction **Germany:** This material is distributed in Germany by J.P. Morgan Securities Ltd. Frankfurt Branch and JPMorgan Chase Bank, N.A., Frankfurt Branch who are regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. **Australia:** This material is issued and distributed by JPMSAL in Australia to "wholesale clients" only. JPMSAL does not issue or distribute this material to "retail clients." The recipient of this material must not distribute it to any third party or outside Australia without the prior written consent of JPMSAL. For the purposes of this paragraph the terms "wholesale client" and "retail client" have the meanings given to them in section 761G of the Corporations Act 2001. **Hong Kong:** The 1% ownership disclosure as of the previous month end satisfies the requirements under Paragraph 16.5(a) of the Hong Kong Code of Conduct for persons licensed by or registered with the Securities and Futures Commission. (For research published within the first ten days of the month, the disclosure may be based on the month end data from two months' prior.) J.P. Morgan Broking (Hong Kong) Limited is the liquidity provider for derivative warrants issued by J.P. Morgan International Derivatives Ltd and listed on The Stock Exchange of Hong Kong Limited. An updated list can be found on HK Ex website: http://www.hkex.com.hk/prod/dw/Lp.htm. Korea: This report may have been edited or contributed to from time to time by affiliates of J.P. Morgan Securities (Far East) Ltd, Seoul branch. Singapore: JPMSI and/or its affiliates may have a holding in any of the securities discussed in this report; for securities where the holding is 1% or greater, the specific holding is disclosed in the Legal Disclosures section above. India: For private circulation only not for sale. **New Zealand:** This material is issued and distributed by JPMSAL in New Zealand only to persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money. JPMSAL does not issue or distribute this material to members of "the public" as determined in accordance with section 3 of the Securities Act 1978. The recipient of this material must not distribute it to any third party or outside New Zealand without the prior written consent of JPMSAL.

General: Additional information is available upon request. Information has been obtained from sources believed to be reliable, but JPMorgan Chase & Co. or its affiliates and/or subsidiaries (collectively JPMorgan) do not warrant its completeness or accuracy except with respect to any disclosures relative to JPMSI and/or its affiliates and the analyst's involvement with the issuer that is the subject of the research. All pricing is as of the close of market for the securities discussed, unless otherwise stated. Opinions and estimates constitute our judgment as of the date of this material and are subject to change without notice. Past performance is not indicative of future results. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients. The recipient of this report must make its own independent decisions regarding any securities or financial instruments mentioned herein. JPMSI distributes in the U.S. research published by non-U.S. affiliates and accepts responsibility for its contents. Periodic updates may be provided on companies/industries based on company specific developments or announcements, market conditions or any other publicly available information. Clients should contact analysts and execute transactions through a JPMorgan subsidiary or affiliate in their home jurisdiction unless governing law permits otherwise.

Copyright 2008 JPMorgan Chase & Co. All rights reserved. This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of JPMorgan.