

Mr. Michael Abbondante
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Dear Mr Abbondante

PricewaterhouseCoopers Submission to the ABS Review of the Consumer Price Index

As the world's largest professional services firm, PwC is a very frequent user of your consumer price index (CPI) to inform our analysis of cost movements across a diverse range of client projects. We are pleased to have the opportunity to participate in this review of CPI.

Review scope

The ABS review is focussed around the following topics

- Principal purpose of the CPI
- Compilation and frequency of the CPI
- Evaluation of the deposit and loan facilities index
- Maintaining the relevance of the CPI
- Commodity classification
- Analytical series and
- 'Other issues'

Principal purpose of the CPI

The principal purpose of the CPI is to provide a general measure of changes in prices of consumer goods and services acquired by Australian households. Overtime CPI has grown in usage and importance particularly for:

- guiding the monetary policy decisions of the Reserve Bank of Australia;
- providing a reference point for wage rise negotiations and decisions; and
- independently informing price escalation levels in a multitude of contracts.
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Since 1996, successive Reserve Bank Governors and Australian Treasurers have agreed that the Reserve Bank should conduct its monetary policy with a view to achieving an inflation rate, as measured by the CPI, of 2-3% per annum on average over the course of the cycle. This provides an 'anchor' for private sector inflation expectations, and enhances the credibility and transparency of the Reserve Bank's monetary policy actions. For these purposes it is important that the consumer price index is widely accepted, including by the general public, as accurately reflecting movements in the general price level. Low inflation and price stability are crucial preconditions for

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sustained growth in economic activity and employment as they assist businesses in making sound investment decisions, underpin the creation of jobs, protect the savings of Australians and preserve the value of the currency.

Compilation and frequency of the CPI

From a macroeconomic perspective, a key deficiency with the CPI is that it is only available quarterly. Improving the measurement of services in the CPI must remain a high priority for the ABS. Australia and New Zealand are the only OECD countries which do not produce CPIs on a monthly basis. Most emerging countries, including most significant countries in East Asia, and the majority of Latin American and Eastern European nations produce monthly CPIs. Given the importance of inflation to the formulation of monetary policy settings to more timely and up-to-date information on inflation trends would be very useful for the central bank, financial market participants and business more generally. The ABS' traditional argument against publishing the CPI monthly is on the grounds of cost. Whilst this is a consideration, we would suggest monthly generation of CPI warrants a high priority and the cost rise could be funded by rationalizing or reducing the frequency of some of the ABS' other publications. The emergence of unofficial monthly measures of consumer price inflation data underscores there is demand for a monthly ABS CPI to ensure better currency of robust, consistent and reliable inflation data.

A second perceived deficiency in the CPI is the exclusive focus on capital cities. Expanding the geographic coverage of the CPI beyond capital cities, through the creation of regional indices, would offer enhanced accuracy in the formulation of regional focused economic policy, wage agreements and contract specification.

We also see merit in further exploring the seasonal adjustments of CPI measures. While the two underlying inflation measures produced by the ABS do help to strip out volatility of short terms noise, we have often found the need to undertake the manual seasonal adjustments of specific time series. The provision of these seasonal adjusted figures would enhance the accuracy and ensure consistency for users who do require such measures of price movements. However, we would not view the provision of seasonally adjusted measures or regionally focused measures as important as increasing the frequency of CPI releases.

Deposit and loan facilities index

The deposit and loan facilities index was introduced into the CPI in 2005 as a proxy for the cost of financial services. It includes direct fees plus a measure of the spread between deposit and retail loan interest rates. Because the latter has increased significantly since the onset of the global financial crisis (GFC), and more recently because some banks have been increasing interest rates on deposits more aggressively, it has had a distorting impact on the 'headline' inflation rate over the past two years, boosting it by 0.4% over the year to the June quarter 2008 and reducing it by 0.7% over the year to the March quarter 2009 (as previous spread 'widenings' dropped out of the annual calculation and as banks began to compete more intensively for deposits as an alternative to wholesale funding). Sophisticated users (including the RBA) are of course able to remove this effect in arriving at an assessment of 'underlying' inflation; but it may have had some undesirable consequences for those who use the CPI in contractual settings which do not allow for the effects of such distortions. It is recognized that the cost of financial services is a part of the 'cost of living'

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but consideration should perhaps be given to an alternative and less distorting way of measuring consumer cost movements for financial services.

Commodity classification

In relation to 'commodity classification', an observation is that by comparison with other major components of the CPI, there is comparatively little detail provided for the 'health' group which now comprises just under 5% of the CPI and has been a significant ongoing source of inflationary pressure over the past decade. For example, at present the CPI only provides four subgroups under 'health', compared with (for example) 12 for the recreation group. Given there is little indication that this inflationary pressures will ease over the coming decade, we see merit in expanding the level of disaggregation, and hence transparency, within this component. While outside of the formal scope of this review, an expansion of the producer price index to capture the input price pressures in delivering health services would compliment these changes to the CPI. This would enhance the ability, and current methodologies, used to track price pressures through the health system.

Analytical series

In relation to 'analytical series' issues (which include five series derived by excluding certain groups or subgroups from the 'headline' measure in order to arrive at a concept of 'underlying' inflation, and two others obtained by dividing the components of the CPI into 'tradeables' and 'non-tradeables'), the need for the first five has been somewhat diminished by the Reserve Bank's focus on the alternative 'trimmed mean' and 'weighted median' measures of underlying inflation (which the ABS now also publishes). It might be preferable instead to replace these with a measure of 'consumer prices excluding food and energy' for comparability with the similar measures produced by many overseas countries and which are widely used overseas as measures of 'underlying' inflation.

PwC does not have any particular concerns with respect to the other issues on which ABS is seeking comment.

Yours sincerely



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