Australian Government

The Treasury

16th Series Australian Consumer Price Index Review

Submission by the Australian Commonwealth Treasury

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1. INTRODUCTION

1.1. Background

1.1.1. The Consumer Price Index (CPI) is a key economic indicator; the CPI series is used extensively in Commonwealth Treasury analysis for the purpose of forecasting, budgeting and economic policy advice.

1.1.2. The CPI series is a key input in the production of the Australian Government's economic forecasts and the Federal Budget. The Treasury forecasts headline CPI, underlying CPI and some CPI sub-components as part of the Joint Economic Forecasting Group (JEFG) rounds in March, September and December. JEFG forecasts form the basis for advice to Government on the current economic outlook. In addition, a significant proportion of Australian Government expenditures, most notably income support payments, are indexed to, or calculated on the basis of, the CPI. The Treasury's CPI forecasts are therefore a key input into the Budget, the Mid Year Fiscal and Economic Outlook (MYEFO) and the Pre-election Economic and Fiscal Outlook (PEFO). The Treasury's analysis of the trends in, and outlook for, the CPI is also a key input into advice to Government on fiscal policy as part of these Budget processes. The Government's official CPI forecasts are published as part of the domestic economic outlook in the Budget and MYEFO.

1.1.3. The CPI series is also a key input into a broad range of the Treasury's policy advice. CPI outcomes are used in Treasury modelling and macro-economic analysis. Examples include the modelling and analysis of the implications of taxation, labour market and climate change policies for the broader economy and for prices. In addition, this analysis assists the Secretary of the Department of Treasury to form a view on monetary policy in his capacity as a member of the Reserve Bank Board.

1.1.4. In this context, two issues covered by the 16th series CPI Review have been identified as of particular relevance to the Treasury in its role as a user of the CPI: ***the evaluation of the deposit and loan facilities sub-index*** and ***the compilation frequency of the CPI***. The following sections of this submission set out the Treasury's view on these issues.

1.1.5. Other issues covered by the Review are considered to be of a lesser relevance to the Treasury in its capacity as a user of the CPI. To the extent that the Treasury has a view on these matters, it will put this forward in its capacity as a member of the CPI Advisory Group. These issues are not addressed in this submission.

2. THE EVALUATION OF THE DEPOSIT AND LOAN FACILITIES SUB-INDEX

2.1. Overview

2.1.1. The deposit and loan facilities sub-index was included in the CPI in the September quarter of 2005 in line with a recommendation of the 13th series CPI Review (the last major review of the CPI).

2.1.2. The deposit and loan facilities sub-index measures the prices of two aspects of deposit and loan facilities: indirect charges associated with interest rate margins; and direct fees and charges paid by households to financial institutions.

2.1.3. Although other countries' consumer price indices routinely cover direct charges, Australia's CPI is unique in its coverage of indirect charges.

2.1.4. The measurement of indirect charges through interest rate margins is also used in the Australian System of National Accounts to measure the price and volume of financial services. The inclusion of indirect charges in the Australian national accounts is in line with the international System of National Accounts (SNA).

2.1.5. In the past few years a relationship between changes in monetary policy and CPI outcomes has been observed. The source of this mechanical relationship is the correlation between the official cash rate and the indirect charges component of the deposit and loan facilities sub-index.

2.1.6. The Treasury is concerned that issues with the current ABS methodology may exaggerate the extent of this correlation.

2.1.7. The CPI is the key measure of consumer price inflation, is critical in the formulation of macroeconomic policy, and is used extensively to index Government payments. The Treasury therefore recommends that he indirect component of the sub-index be removed until such time as satisfactory changes to the measurement methodology.

2.2. Measurement of indirect charges for financial services

2.2.1. The main services provided by deposit taking institutions to households relate to intermediation and transaction services.

2.2.2. Deposit taking institutions generate profits: directly through account and transaction fees; and indirectly through lending at interest rates higher than their cost of funds. In line with the CPI's conceptual basis, both direct and indirect charges paid by households in acquiring financial services from deposit taking institutions should, in theory, be factored into the CPI.

2.2.3. Measuring indirect charges through differences in interest rates is known as Financial Intermediation Services Indirectly Measured (FISIM).

2.2.4. One way of measuring FISIM, as is suggested in the SNA 93, would be to net out the interest flows between deposit taking institutions and households that are associated with intermediation. Movements in this net interest flow, not accounted for by changes in the balance of loans, would provide a measure of indirect charges for intermediation services.

2.2.5. However, this approach is difficult to implement as deposit taking institutions earn interest on balances other than loans to domestic households and borrow funds from sources other than domestic households.

2.2.6. The SNA 93 suggests an equivalent procedure based on measuring the margins between deposit and loan rates, and the risk-free reference rate. These two margins provide a measure of the indirect charges on deposits and loans respectively.

2.2.7. However, the current ABS methodology sets the "reference rate" as the mid-point of all deposit and loan rates in the economy, rather than the risk-free rate (or a proxy such as the interbank lending rate). The ABS employs this methodology to avoid negative margins that would occur when the risk-free rate is less than deposit rate.

2.3. Issues associated with the current measurement approach

2.3.1. The deposit and loan facilities sub-index presents challenges to monetary policy implementation similar to those generated by the mortgage interest payments component that was discontinued following the 13th series CPI Review.

2.3.2. As noted in the Treasury's submission to that Review, the contemporary policy focus on maintaining a low inflation environment requires a suitable, accurate and high profile measure of inflation. The removal of interest payments in 1998 recognised the CPI's widely accepted role as the key measure of consumer price inflation and target of monetary policy.

2.3.3. While the direct charges component of the deposit and loan facilities sub-index is considered satisfactory, the methodology for measuring the indirect charges component presents issues similar to those associated with the mortgage interest rate series.

2.3.4. Since its inception in 2005, a strong positive correlation has, at times, been observed between changes in the official cash rate and the deposit and loan facilities sub-index. This effect can be large as the deposit and loan facilities expenditure class represents around 45 per cent of the financial services group within the CPI and an effective expenditure weight of around 4 per cent of the total CPI basket.

2.3.5. There have been a number of occasions when movements in the deposit and loan facilities sub-index has materially affected the headline CPI result. For example, a fall in the sub-index reduced annual headline inflation by around 1 percentage point in the June quarter of 2009 following sharp falls in the cash

rate. Conversely, the sub-index contributed ½ of a percentage point to annual headline inflation in the June quarter of 2008 following a period of monetary policy tightening.

2.3.6. The key concern is that mismeasurement of indirect charges may be generating a feedback loop between monetary policy and the CPI, whereby tighter monetary policy contributes to a higher CPI result and vice versa. The movement in the sub-index, and therefore the headline CPI, seems purely mechanical rather than reflective of underlying price pressures. As a result, the Treasury's outlook for the deposit and loan facilities sub-index is now formed in isolation to the outlook for prices in general, which is an unsatisfactory situation. These mismeasurement issues may reflect data quality issues, for example, out-of-date data sources or mismeasured variables.

2.3.7. Co-movements in the sub-index with the cash rate may reflect a genuine movement in the price of inter-mediation; however, the observed quantum of the movement appears to significantly overstate this relationship.

2.3.8. The Treasury notes that the ABS is currently undertaking further analysis of the measurement methodology as part of a broader investigation of its FISM methodology. A change to the methodology is therefore likely to affect measurement of financial services in the national accounts, as well as the 16th series CPI Review.

2.3.9. The Treasury considers that the current approach to measuring deposit and loan facilities is inappropriate and that the indirect component of the deposit and loan facilities sub-index should be removed from the CPI until such time as a satisfactory change to the methodology can be made.

3. THE COMPILATION FREQUENCY OF THE CPI

3.1. Overview

3.1.1. The Treasury is of the view that there are potential benefits associated with an increase in the compilation frequency of the CPI. However, these potential benefits must be carefully weighed against any additional production costs and/or reductions in data quality. In order to make an overall assessment of the move to monthly compilation of the CPI, the Treasury will require further information from the ABS in this regard.

3.2. Advantages of monthly CPI compilation

3.2.1. An increase in the CPI compilation frequency from quarterly to monthly will improve the timeliness and potentially the richness of the data available for economic analysis. It will also better facilitate international comparisons.

Timeliness of the information set

3.2.2. Monthly compilation of the CPI would provide more timely data.

3.2.3. The CPI series is a key input in the production of the Treasury's economic forecasts for the JEFG and the Budget. The CPI data underpins the Treasury forecasts, with greater weight tending to be placed on recent outcomes. This is particularly relevant for short-term forecasts and forecasting models that contain lags of CPI outcomes in their equations, reflecting the persistence of inflation. The less timely CPI outcomes used, the less reliable the forecasts tend to be (at least in the short term).

3.2.4. In the case of the Budget, which occurs in May every year, recent CPI data are quite timely, with CPI outcomes for the March quarter available in late April. However, timely CPI outcomes are generally not available for the JEFG rounds that occur in March, September and December, and are often not available for the PEFO in election years.

3.2.5. For example, in the September JEFG round, the most recent CPI outcome is for the June quarter (as released at the end of July). This means that the most recent CPI outcome is almost three months out of date when the JEFG forecasts are being finalised. The impact of this delay on forecast accuracy and reliability will depend on the speed of economic events; however, timelier data will almost certainly lead to improvements.

3.2.6. As noted, the CPI is also a key input in the preparation of monetary policy advice. The Secretary of the Department of Treasury sits on the Reserve Bank Board and the Department is tasked with providing advice in support of this role. In addition to the benefits to economic analysis outlined above, a sufficiently stable and accurate monthly series could help ensure that any unanticipated movements in inflation were recognised and acted upon promptly, therefore aiding economic stability.

Richness of the information set

3.2.7. Monthly compilation of the CPI has the potential to provide a richer data set.

3.2.8. A monthly compilation of the CPI will require the ABS to collect additional price information in each month. This additional information should improve the quality of the existing quarterly series.

3.2.9. A monthly series will also provide additional observations for use in Treasury analysis. For most Australian macro-economic variables, the time series is already quite large. However, where relationships change over time, this may restrict analysis to more recent periods, which increases the importance of compilation frequency in providing a sufficient sample size.

Facilitation of international comparisons

3.2.10. Monthly compilation of the CPI would also assist in international comparisons of inflation outcomes. The International Monetary Fund's (IMF) Special Data Dissemination Standard (SDDS), an international standard for advanced economies, prescribes a monthly periodicity for the release of the CPI data. Australia has subscribed to the IMF SDDS since its inception in 1996. However, the SDDS provides flexibility provisions in the frequency requirement, of which Australia currently avails itself in relation to its consumer price data. However, Australia is the only one of the 64 SDDS subscribers not to publish a monthly prices series. The IMF has noted that, as a general proposition, the benefits of transparency and disclosure, particularly with regard to the more efficient functioning of markets, tend to increase with the timeliness of information.

3.3. Alternative monthly indicators

3.3.1. At present there is only one other direct source of information on monthly consumer price outcomes: the TD-Securities – Melbourne Institute monthly Inflation Gauge, which is available on subscription. This indicator is a useful reference in between the quarterly CPI releases. However, it is not a reliable substitute for a monthly ABS series. This has been highlighted by the divergence between the TD-Securities – Melbourne Institute monthly Inflation Gauge and the CPI in recent years.

3.4. Production cost and data quality considerations

Production cost implications

3.4.1. Treasury analysis will almost invariably benefit from a more timely and richer data set. However, the cost implications of the production of this data set must be carefully assessed. In order to make an overall assessment of the move to monthly compilation, the Treasury will require further information on the nature of the additional costs and the intended sources of funding.

3.4.2. If resources are to be diverted from other ABS functions, it will be important that the quality of other key data is not unduly compromised. While an

increased in the frequency of the CPI compilation would be valuable, it must not be allowed to come at the cost of a reduction in the quality of other, potentially more critical, ABS data. Indeed, it is important to ensure the ongoing quality of key existing economic data, for example, national accounts data.

3.4.3. If additional resources are sought, this will need to be carefully assessed against competing Government expenditure priorities. As these could include other ABS activities, the Treasury would appreciate the opportunity to participate in a broader discussion about ABS priorities prior to such a bid going forward.

Data quality implications

3.4.4. It will be important that the move to a monthly compilation frequency will not unduly compromise the quality of the CPI.

3.4.5. The Treasury notes that a timely, monthly series, by its nature, will contain more noise and will receive less scrutiny than occurs with quarterly compilation. It will be important that the more compressed timeline does not unduly reduce the quality of the resulting CPI series or negatively impact the reputation of the CPI as an authoritative measure of inflation.