

# Australian CPI preview and index changes

## Australian Inflation-Linked Bonds update

October 2011

- The Australian Bureau of Statistics (ABS) has announced an extensive review of the Australian Consumer Price Index with changes to be introduced in the Q311 release on 26 October 2011.
- The ABS has made it clear that the current, non-seasonally adjusted, headline CPI will continue to be the official measure of inflation in Australia, especially in relation to the inflation-linked bond market and other contracts.
- The proposed changes to the CPI calculation are unlikely to have a significant impact on annual inflation, but quarterly inflation moves will be impacted and may add to the statistical noise around any inflation release.
- This will make the first release of these new measures more of a challenge to interpret, and comes at a crucial time for future path of interest rates in Australia, with the Reserve Bank signalling a potential easing of monetary policy based on the next CPI release.

### Australian CPI preview and index changes

In December 2010, the Australian Bureau of Statistics (ABS) completed an extensive review of the Australian Consumer Price Index (CPI). As a result, there are a number of important changes to be made in the 16<sup>th</sup> series of the CPI, the first release of which is due 26 October 2011 for Q311.

There has been speculation over how these changes will impact on the headline CPI and interpretation by the Reserve Bank of Australia (RBA) when setting the official cash rate. The ABS has made it clear that the non-seasonally adjusted headline CPI will continue to be the official measure of inflation and will be the measure used in the awarding of minimum wages contracts and in the inflation linked bond market.

The ABS will, however, begin publishing a seasonally adjusted headline rate and introduce new seasonal adjustment factors for underlying inflation. These new measures of inflation are due to be released at what is a critical point for the setting of interest rates in Australia. The next RBA meeting is on 1 November 2011, after the release of Q3 11 CPI figures and could potentially see the RBA ease monetary policy after shifting to a more dovish stance at the October board meeting.

However, the methodology changes of the 16<sup>th</sup> series of the CPI are unlikely to have a significant impact on inflation, but the measurement of inflation will be effected, going forward.

## Changes to the CPI

The ABS has announced several changes to the CPI release in the 16th series to begin Q3 11. These include:

- The introduction of a seasonally adjusted version of headline inflation.
- The introduction of a core inflation measure, i.e. ex food and energy.
- Revised measures of underlying inflation - trimmed mean and weighted median measures of inflation using standard ABS seasonal adjustment techniques (rather than the previous RBA seasonal adjustment technique).
- The headline inflation measure will also change its measurement of financial services costs.
- New expenditure class weights will be introduced after the 2009/10 Household Expenditure Survey.

As always the 16<sup>th</sup> series will be linked to the 15<sup>th</sup> series and no revisions of past data will take place to prior headline CPI data. However as described below, there could be revisions to the underlying CPI, which could be significant for the RBA's monetary policy decision on 1 November 2011 and other decisions in the future.

### Seasonally adjusted measure

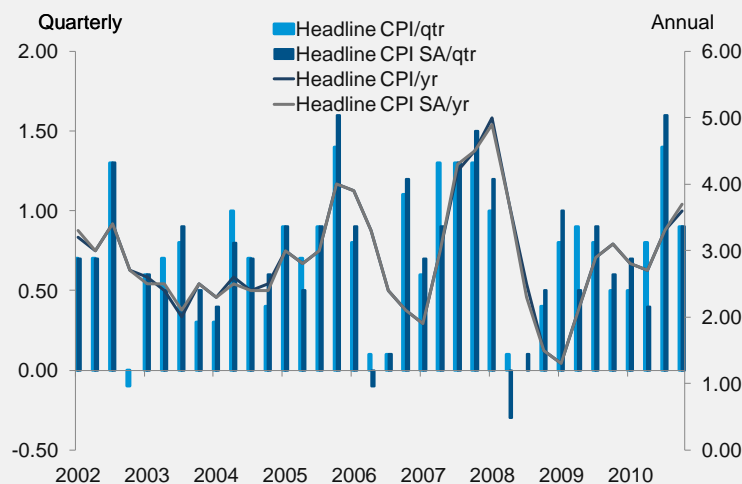
A new seasonally adjusted headline CPI will now be produced. Importantly, the original headline CPI will continue to be the official inflation measure and will not be subject to revision.

However the seasonally adjusted measure will be subject to revision from quarter to quarter, as the seasonal factors are updated using the latest available data, this is called concurrent seasonal adjustment.

In the non-seasonally adjusted measure it has been found that Q1 is typically higher and Q4 is typically low. This makes sense given regular seasonal influences, such as education price rises generally occur in Q1.

As the chart below shows, the quarterly price movements between the seasonally adjusted headline CPI and the original measure are different. However, over the long term price movements should converge. Therefore annual inflation should be broadly the same between the two measures over time.

**Headline inflation (%) –seasonally adjusted vs original measure**



Source: ABS, CFS GAM. Data to 30 June 2011

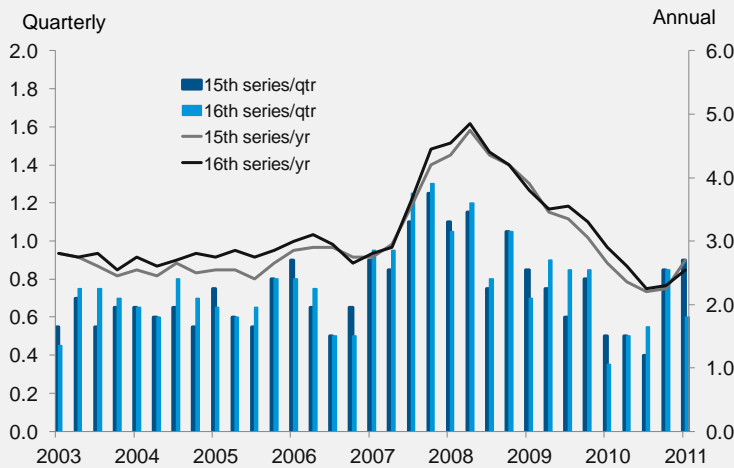
**Changes to seasonal adjustment of underlying inflation**

The seasonal adjustment methodology of the trimmed mean and weighted median has been updated as part of the 16th series release. The ABS will continue to produce analytical measures of underlying inflation, but the current RBA seasonal adjustment methods will be replaced by standard ABS seasonal adjustment methods.

As a consequence a wider range of subcomponents will be subject to seasonal adjustment. In the 15th series of the CPI, 20 out of the 90 expenditure classes were deemed as seasonal and were adjusted. In the 16th series, 64 out of 90 are deemed as seasonal and will be adjusted.

Some examples include, hospital and medical services are now classified as having seasonal influences with Q1 seasonally low and Q2 seasonally high. The other major change is that automotive fuel is now considered to be seasonal. The fact that these two expenditure classes now are deemed to be seasonally adjusted has had the largest impact on underlying CPI. The biggest changes in the new 16th series for underlying inflation is that Q2 figures are now 10 basis points lower on average. See chart below.

**Underlying inflation (%) –comparison of seasonally adjustment methodology**



Source: ABS, CFS GAM. Data to 30 June 2011

These changes have led to some sizeable revisions of quarterly inflation for 2011. For example, the Q2 11 underlying inflation rate is now recorded as +0.6%/qtr (was 0.9% on the 15th series seasonal adjustments). Underlying annual inflation was also lower at 2.6%/yr, prior was 2.7%.

Overall the new seasonal adjustments show a slightly lower inflation pipeline for the RBA to consider over 2011 and could see the RBA downgrade its inflation forecasts in the next Statement on Monetary Policy due 4 November 2011.

Note: the ABS has warned that “moving to the standard ABS seasonal adjustment methodology will result in a greater than usual number of revisions to the historical series when first published in the September quarter 2011 for the Weighted median and Trimmed mean”. These revisions are likely to make it harder for financial markets to interpret the Q3 11 inflation readings and the 2011 inflation pipeline and what it will mean for the RBA decision on 1 November 2011.

### Changes to the measurement of financial services costs:

The ABS has also announced it will change its measurement of financial services costs in the 16th series CPI given adverse feedback over the component. The measure has a high correlation to the interest rate cycle and has been difficult to forecast accurately.

The removal of this indirect measure from Q3 11 is likely to lower the annual rate of inflation going forward, especially in a period when interest rates are rising.

The Deposit and loan facilities index will now comprise direct fees and charges only and will be renamed 'Deposit and loan facilities - direct fees'. An indirect measure is hoped to be reintroduced in the 17th series when there is a more robust framework for measuring the series. In the meantime, a new analytical series, comprising the Headline CPI inclusive of FISIM, will be published on a quarterly basis from the commencement of the 16th series for interested parties.

### Household Expenditure Survey

As part of the 16th release of the CPI, new weights will also be used to compile the CPI basket. These new weights are based on the 2009/10 Household Expenditure Survey (HES) and can be found in the table below.

The largest change to weights includes an up weighting of food and housing, largely reflecting a higher weight for rents and home purchases. Recreation has also seen a large increase in weight. This could reflect the increase in household income seen over the period between the two surveys and the continuing shift to the consumption of services versus household goods and apparel. Between 2003/04 and 2009/10 the mean gross household income per week increased by 50%, spending rose 38% and inflation by 19%.

The major down weight in this series includes finance & insurance, due to the removal of the deposit and loan facility. Transportation is also lower, due to a lower weight for motor vehicles. The 16th series of the CPI will now include both used and new vehicles for the first time. Overall the change in weights for the 16th series is unlikely to have a material impact on inflation.

Group	16 <sup>th</sup> series (new weights)	15 <sup>th</sup> series (old weights)
Food and non-alcoholic beverages	16.84%	15.44%
Alcohol and tobacco	7.06%	6.79%
Clothing and footwear	3.98%	3.91%
Housing	22.30%	19.53%
Furnishings, household equipment and services	9.10%	9.62%
Health	5.29%	4.70%
Transport	11.55%	13.11%
Communication	3.05%	3.31%
Recreation and culture	12.56%	11.55%
Education	3.18%	2.73%
Insurance and Financial Services	5.08%	9.31%
Total	100%	100%

### Some interesting facts from HES

The Household Expenditure Survey found that the biggest changes in consumption patterns since the 2003/04 survey were:

- internet charges (up 152%)
- pay TV fees (up 95%)
- interest payments on mortgages (up 75%),
- meals in restaurants, hotels, clubs and related (up 68%)
- child care (up 84%)
- rent payments (up 68%)
- meals out and fast foods (up 50%)
- recreational and educational services (up 50%)

### Prospect for monthly CPI

The ABS continues to support the view that Australia would be well served by a monthly CPI. This was supported by feedback to the proposed changes to the 16th series of the CPI.

The ABS is “persuaded there would be a significant benefit from more timely and responsive economic management if a CPI of equivalent quality to the current quarterly index were available monthly”.

Significantly, however, the ABS has noted that “additional funding will be required to meet the costs involved in compiling a monthly index”. At this stage, therefore, the prospects for a monthly CPI look slim as does moving the HES to a four year cycle, rather than the current six year cycle.

### Potential impact on RBA

At the RBA board meeting on 4 October 2011, the Governor made the following statement:

*“Taking into account all the recent information, the path for inflation may now be more consistent with the 2–3 per cent target in 2012 and 2013, abstracting from the impact of the carbon pricing scheme. This assessment will be reviewed on receipt of further data on prices ahead of the Board's next meeting. An improved inflation outlook would increase the scope for monetary policy to provide some support to demand, should that prove necessary”*

The release of Q3 11 CPI data on 26 October 2011 will therefore be important for the future path of interest rates in Australia.

It is expected that the RBA will continue to use the underlying measure of inflation (the average of the weighted median and trimmed mean) as the best guide to medium term inflation pressures. The recent changes to the CPI should not impact this read through, although they will likely to add to the noise surrounding this release.

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