29 November 2018

Mr Leigh Merrington
Director
Economic Research Section
Australian Bureau of Statistics
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By email: leigh.merrington@abs.gov.au

Dear Mr Merrington,

Monthly Publication of the Consumer Price Index

Introduction

AFMA welcomes the opportunity to comment on the initiative of the Australian Bureau of Statistics (ABS) to publish Australian inflation data as measured by the Consumer Price Index (CPI) on a monthly basis rather than a quarterly basis. The move to more frequent publication of inflation data has the broad support of AFMA's members who believe that it will contribute to more effective hedging and trading of interest rate and inflation linked products which will facilitate better transmission of monetary policy through the economy.

Inflation has been subdued in many advanced economies for several years but it remains the major macroeconomic factor in determining monetary policy for many of the central banks that operate in those economies. More than thirty central banks use inflation targeting as a central tenet of their monetary policy including the Reserve Bank of Australia (RBA). An inflation-targeting central bank adjusts monetary policy settings by raising or lowering official interest rates based on above-target or below-target inflation data. The Consumer Price Index (CPI) is a significant inflation benchmark index for the Australian economy and the one of the most important inputs into the RBA's monetary policy deliberations.

This important input into the RBA's monetary policy decision-making process is also one of the least timely by international standards. Australia is one of the few countries in the world to publish its primary inflation data on a quarterly rather than a monthly basis. It is important for inflation information to be released in a timely manner to foment a forward-looking and pre-emptive approach to monetary policy.

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Monetary Policy and Inflation Expectations

The capacity of financial markets to transmit monetary policy to the real economy depends on market participants' collective future inflation expectations and the anticipation of adjustments to the official interest rate by the central bank.

The lack of timeliness in compiling and issuing inflation data potentially gives monetary policy a backward-looking bias. This is suggested by the fact that changes in the official cash rate occur most frequently at the monthly RBA Board meeting immediately following the quarterly CPI release. For example, during the 2002-08 tightening episode, 67 per cent of interest rate changes followed this pattern, including every one of the six increases in the cash rate from May 2006 to February 2008.[1] This suggests the RBA may sometimes delay policy action by one or two months while it waits for the latest inflation data. This is also potentially confusing to the public and their inflation expectations, implying that the RBA is passively responding to past inflation outcomes rather than actively targeting the future path of inflation.

Central banks smooth changes in interest rates over time, to minimise the risk of policy errors. Some of this risk arises from the seasonality of inflation data. This is made more challenging by the lag between publication of quarterly data and the seasonal adjustments the ABS must make to establish the underlying trend. The publication of monthly data would help facilitate a gradualist approach to monetary policy where more frequent data would reduce the impact of seasonality and lead to more timely policy action.

A monthly CPI release would ensure that each Reserve Bank Board meeting had the benefit of an update on the inflation rate, which also serves as the baseline for the RBA's inflation forecast. The RBA would no longer have a bias to changing interest rates in the wake of the quarterly CPI release. The RBA and financial markets could more quickly identify potential turning points in the inflation rate and the economy.

The RBA's submission to the ABS's 16th CPI Review noted that:

> *More timely data. It could also be helpful in distinguishing between signal and noise. In recent years there have been a couple of instances of quarterly readings for inflation that subsequently proved not to be representative of the general trend. The greater frequency of monthly data is likely to allow earlier identification of situations where an observation is unrepresentative*.[2]

The Role of Wholesale Financial Markets in Monetary Policy Transmission

The broad functions of interest rate, credit and debt markets facilitate the transmission of a central bank's monetary policy through interest rate and credit channels, establish a base rate of interest upon which all other short term and long term interest rates are priced off, thereby creating a yield curve and providing a funding base for all investments.

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[1] Dr Stephen Kirchner, "Benefits Grow in Monthly CPI Data," *Canberra Times*, March 1, 2010, http://www.institutional-economics.com/images/uploads/ctoped1mar10.pdf.

[2] Reserve Bank of Australia. Economic Group, "Submission to the 16th Series Review of the Consumer Price Index" (Reserve Bank of Australia, March 2010), 1–2, http://www.rba.gov.au/publications/submissions/prices/16th-series-review-of-cpi/pdf/16th-series-review-of-cpi.pdf.

The successful transmission of monetary policy through the economy relies upon the efficient operation of wholesale financial markets to transmit changes in the official interest rate to borrowing and lending rates in the real economy. The capacity of the money markets to transmit policy intentions depends not only on the monetary policy itself but also on the operational behaviour of the central bank in the market.

Inflation expectations and expectations for monetary policy are drivers of trading activity in short term and long term interest rate markets. Interest rate traders determine their hedging requirements and trading strategies by forecasting the likely shape of the yield curve in the future. The shape of the yield curve reflects the analysis and forecasts of all market participants' expectations for how monetary policy and official interest rates will evolve over time.

AFMA's members and market participants strongly support the move to monthly publication and have been advocating for the move for several years.[3] Discussions with members of AFMA's technical market committees confirm that the majority of participants trading in interest rate markets favour more frequent publication of the inflation data.

Short Term Interest Rates

Prices of securities in short term interest rate markets are heavily influenced by participants' inflation expectations and expectations for monetary policy. These markets include money market loans and deposits, certificates of deposits, bank bills, commercial paper and forward foreign exchange. The level of interest rates in these markets indirectly influence interest rates in the real economy and determine the level of interest that small, medium and large businesses will have to pay on their loans. Having more timely and accurate data would assist these markets to trade more efficiently because more frequent publication would help provide an earlier indication of the trend in inflation.

Efficient money markets contribute to a reduction in liquidity and credit risk premiums for financial market participants, allowing for a smoother functioning of the payments system. Stable financing conditions in the economy contribute to financial stability.

Inflation Linked Fixed Income Products

Long term, fixed income products are also impacted by inflation. Inflation can have a dampening effect on investment returns and can cut deeply into investment return value if there is no offset for the risk of inflation. Inflation linked bonds are a unique asset class because they offer a nearly perfect hedge against inflation, while also having a low correlation to other risk assets. Institutional investors, such as superannuation fund managers, choose to purchase inflation linked bonds for their portfolios because they provide protection for both income and capital against inflation.

Inflation linked bonds provide diversification for Australians operating self-managed superannuation funds who are either approaching retirement or are already retired. Those approaching retirement and still in the accumulation phase can protect themselves from inflation by investing in capital indexed bonds. Those SMSF investors already in retirement, without the protection of a wage and in the drawdown phase, can invest in indexed annuity bonds, helping to return capital and to meet minimum withdrawal requirements as investors age.

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[3] Paul Bloxham, "Monthly Measure of Inflation Needed," *The Australian*, October 4, 2010, http://www.theaustralian.com.au/business/monthly-measure-of-inflation-needed/story-e6frg8zx-1225933517558.

There is strong participation in Australia's nominal, government and corporate bond markets by offshore investors, especially Asian investors. A monthly CPI would help to facilitate offshore participation in Australia's inflation indexed bond market and could be expected to increase offshore holdings of Treasury indexed bonds (TIBs). Globally, most inflation-linked bonds are priced based on the Canadian Treasury model for the indexation of cash flows on a monthly basis. Australian inflation indexed bonds do not fit neatly into global bond portfolios based on a quarterly CPI and would benefit from harmonisation with the global standard.

Benefits

Funding for the proposed change to monthly publication has, we understand, been an issue in past years and while the RBA and financial markets would welcome a monthly CPI, there was some resistance to the idea due to the increased cost of a monthly data collection which could potentially outweigh the benefits to users. If a higher frequency CPI leads to more timely monetary policy action and better transmission of policy, the economy-wide benefits could be very large. Most other developed countries have decided that a monthly CPI is worth the cost. It would be surprising if the costs and benefits in Australia were very different. AFMA recommends that the ABS produce the CPI at a monthly frequency and that the Government should appropriately fund this change given the likely economy-wide benefits.

Yours sincerely

Mark McCarthy

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