

## Box D: Implications for Monetary Policy of Changes to the CPI<sup>1</sup>

Since 1993, the conduct of monetary policy in Australia has been based on an inflation target. The *Statement on the Conduct of Monetary Policy*, issued by the Treasurer and the Governor in 1996, formalised the target as 'keeping underlying inflation between 2 and 3 per cent, on average, over the cycle'. Although no specific measure of underlying inflation was referred to in this statement, it has been customary to evaluate monetary policy in terms of the so-called 'Treasury underlying' rate. Other measures of underlying or core inflation can be calculated, but on any measure, it is clear that the inflation target has been achieved in the 1990s (Table D1).

The concept of underlying inflation has been used to avoid the distortions associated with the most common measure of inflation – the Consumer Price Index (CPI).

**Table D1: Consumer Prices**

Average rate of increase;  
per cent per annum

1990–98 1993–98

**Underlying measures<sup>(a)</sup>**

Treasury underlying CPI	2.4	2.1
Private-sector goods and services	2.5	2.2
Median price change	2.3	2.0
Trimmed mean price change	2.5	2.1
<b>CPI measures</b>		
Consumer price index	2.1	2.0
'Acquisitions' CPI	2.6	2.3

(a) For definitions, see 'Measuring Underlying Inflation', *Reserve Bank of Australia Bulletin*, August 1994.

The main difficulty with using the CPI to evaluate monetary policy has been the inclusion, since 1986, of mortgage interest charges as a measure of the cost of owner-occupied housing. Ideally, for monetary policy purposes, a consumer price index should measure changes in the price of consumer goods and services and not the price of assets or the costs associated with financing their acquisition. Moreover, the inclusion of interest rates meant that the CPI would move perversely following a change in the monetary policy instrument: a rise in interest rates aimed at reducing medium-term inflation pressures would push the measured CPI *up* in the short term.

Recently, the Australian Bureau of Statistics implemented changes to the calculation of the CPI which will significantly reduce the problems in using the published CPI to evaluate monetary policy. Beginning with the September quarter release, the CPI is now being constructed using an 'acquisitions' approach to measuring prices, rather than the 'outlays' approach used previously. As a consequence, the cost of housing services for owner occupiers will now be measured by the cost of acquiring a new dwelling (excluding land) rather than the outlays involved in servicing the mortgage which financed the purchase.

The behaviour of the new CPI is not known with certainty, but a reasonable guide from recent history can be obtained by substituting an index of prices of new dwellings for interest charges in the existing CPI. This is the series labelled 'acquisitions' CPI in Graph D1. This shows that the 'acquisitions' measure is much less volatile than the CPI, demonstrating that much of

1. For a more detailed discussion of these issues, see 'The Implications of Recent Changes to the Consumer Price Index for Monetary Policy and the Inflation Target', *Reserve Bank of Australia Bulletin*, October 1998, pp. 1–5.

the observed volatility in the CPI was induced by the inclusion of interest rates.

Since 1990, the average rates of inflation as measured by these series were each between 2 and 3 per cent (Table D1). Over this particular period, the 'acquisitions' CPI recorded a slightly higher rate of inflation, on average, than the underlying series – by a few tenths of a percentage point per year. This is because prices for certain items excluded from the underlying series (in particular, tobacco and health) have recorded higher rates of increase than the

average over the period. Overall, however, the trends are not markedly different and it seems unlikely that the conduct of monetary policy would have been different had the target been specified in terms of an acquisitions-based CPI rather than underlying inflation.

On the assumption that the 'acquisitions' CPI above is a reasonable guide to the behaviour of the new CPI, and given the wider community recognition of the CPI, the Bank's judgment is that the inflation target – maintaining inflation of 2–3 per cent on average over time – can now be understood as referring to the published CPI. The CPI will still be affected from time to time by temporary factors which do not signify persistent trends in inflation, but given the average nature of the target such fluctuations should not make for too many problems for policy. Of course, the Bank will continue to analyse underlying inflation measures, as these can be informative about the influence of such temporary factors on the CPI.

The Treasurer has agreed that this approach is consistent with the intent of the *Statement on the Conduct of Monetary Policy* of August 1996. ✎

**Graph D1**

