MERCER

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INFLATION
Some thoughts
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What is inflation?

Consultation

RPI vs CPI

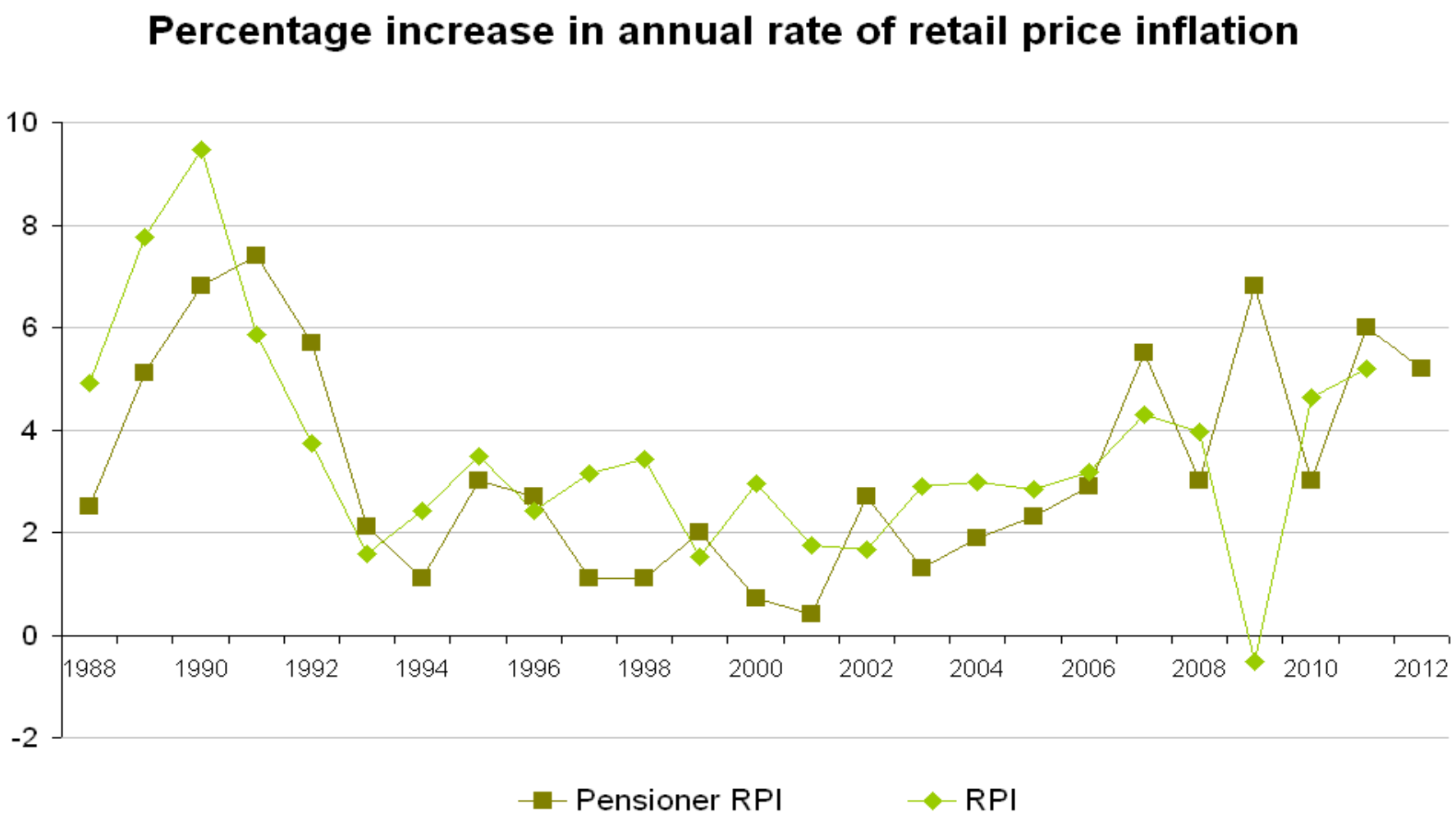
Definition of National Statistic

Why does it matter and what's next?

What is inflation?
RPI vs. CPI

- CPI is the UK's version of the Harmonised Index of Consumer Prices (HICP)
  - Constituent parts follow an internationally agreed standard
  - Developed by EC as test for entry into the European Monetary Union
  - Basket of goods and calculation governed by the European Union
  - Includes spending by institutions as well as individuals
  - Excludes some expenditure included in RPI, for example:
    - TV and road licenses
    - Certain owner occupied housing costs (eg mortgage interest payments and council tax)
- RPI produced in its current from since 1956
  - Based on actual spending patterns in the UK
  - Excludes some goods (eg financial services charges) included in CPI

What is inflation?
Whose inflation?



What is inflation?
Whose inflation?



Consultation

- To address the gap between measures of inflation produced by the Retail Prices Index (RPI) and the Consumer Prices Index (CPI).
- Changes to RPI formula only

Option 1 – No change

Option 2: Change one particular approach to averaging changes in prices for clothing.

Option 3: Change one particular approach to averaging changes in prices for all categories

Option 4: Change the RPI so that its formulae align fully with those used in the CPI.

Consultation

- Majority of responses wanted no change
- National Statistician said:
  - Significant value to users in maintaining the continuity of the existing RPI's time series without major change.
  - The formulae used at the elementary aggregate level in the RPI should remain unchanged.
  - Carli formula would not be chosen were ONS constructing a new price index.
  - There is no error in the RPI. The RPI is constructed and calculated as defined in the Consumer Price Indices Technical Manual.
  - ONS will introduce RPIJ which will be based on the RPI but replaces the Carli formula with the Jevons formula.

RPI vs. CPI

- Differences between the RPI and CPI
  - Population base
  - Basket of goods
  - Formulae used to calculate elementary aggregates

Formula	RPI	CPI
Carli	27%	0%
Dutot	29%	5%
Jevons	0%	63%
Other/weighted formula	43%	33%

RPI vs. CPI

Three items priced (respectively):

- A, B and C at time 1 and
- X, Y and Z at time 2, then:

Carli	[(X÷A) + (Y÷B) + (Z÷C)] ÷ 3
Dutot	(X+Y+Z) ÷ (A+B+C)
Jevons	[(X×Y×Z) ÷ (A×B×C)] ^ (1/3)

RPI vs. CPI

Three dresses priced (respectively):

- £10, £30 and £100 at time 1 and
- £10, £35 and £200 at time 2, then:

Carli measure of inflation is 39%

Dutot: measure of inflation is 75%

Jevons: measure of inflation is 33%







RPI vs. CPI

- Carli always at least as high as Jevons
- Carli risks overstating inflation
  - But not necessarily
    - Depends on ‘inflation’ being measured
    - Depends on how basket of goods is constructed
- Jevons risks understating inflation
  - Assumption of ‘substitution’ at elementary aggregate level only works if different items can genuinely be substituted without any loss of ‘utility’
  - Sometimes not practically possible
    - Eg someone who can only access local store
  - Sometimes elementary aggregates not sufficiently homogeneous
    - Clothing categories

Definition of National Statistic
Status of RPI

- Statutory definition
  - Statistics and Registration Services Act 2007 (SRSA) requires UK Statistics Authority (UKSA) to maintain a Code of Practice for Official Statistics setting out the principles and protocols that must be met for a statistic to be deemed a 'National Statistic'.
- Code requires the UKSA to seek 'continuous improvement in statistical processes'.
- National Statistician's decision that the RPI formula would no longer be reviewed means it fails the 'continuous improvement' test
  - So RPI cannot be a 'National Statistic'
- The SRSA requires the UKSA to publish the RPI monthly, and so will continue to do so.

Definition of National Statistic
Status of RPI

- RPI is an 'official statistic'
- Calculation must be carried out to a similarly high quality as required under Code of Practice
- Decision regarding RPI's status does not affect whether it can continue to be used
  - To determine pension increases,
  - Yields on index linked gilts, or
  - Payments under business contracts.
- Where scheme rules require RPI-linked increases, then the decision not to denote RPI as a National Statistic is likely to be irrelevant
  - Unless the rules also refer to this status or have a degree of ambiguity/choice as to what index to use
    - This isn't a legal opinion.

Why does it matter?
Defined benefit pension schemes

- Statutory requirements
  - Deferred revaluation
    - The percentage which appears to the Secretary of State to be the percentage increase in the general level of prices in Great Britain during the period which is the reference period in relation to the revaluation period.
  - Pension increases
    - Pension …must be increased annually by at least the 'appropriate percentage'
    - Appropriate percentage refers back to deferred revaluation rules
- Also scheme rules

Why does it matter?
Other

RPI also used in:

- Index linked government bonds
- Regulated prices (eg rail fares)
- Private and public sector contract terms
- Some tax thresholds or levies

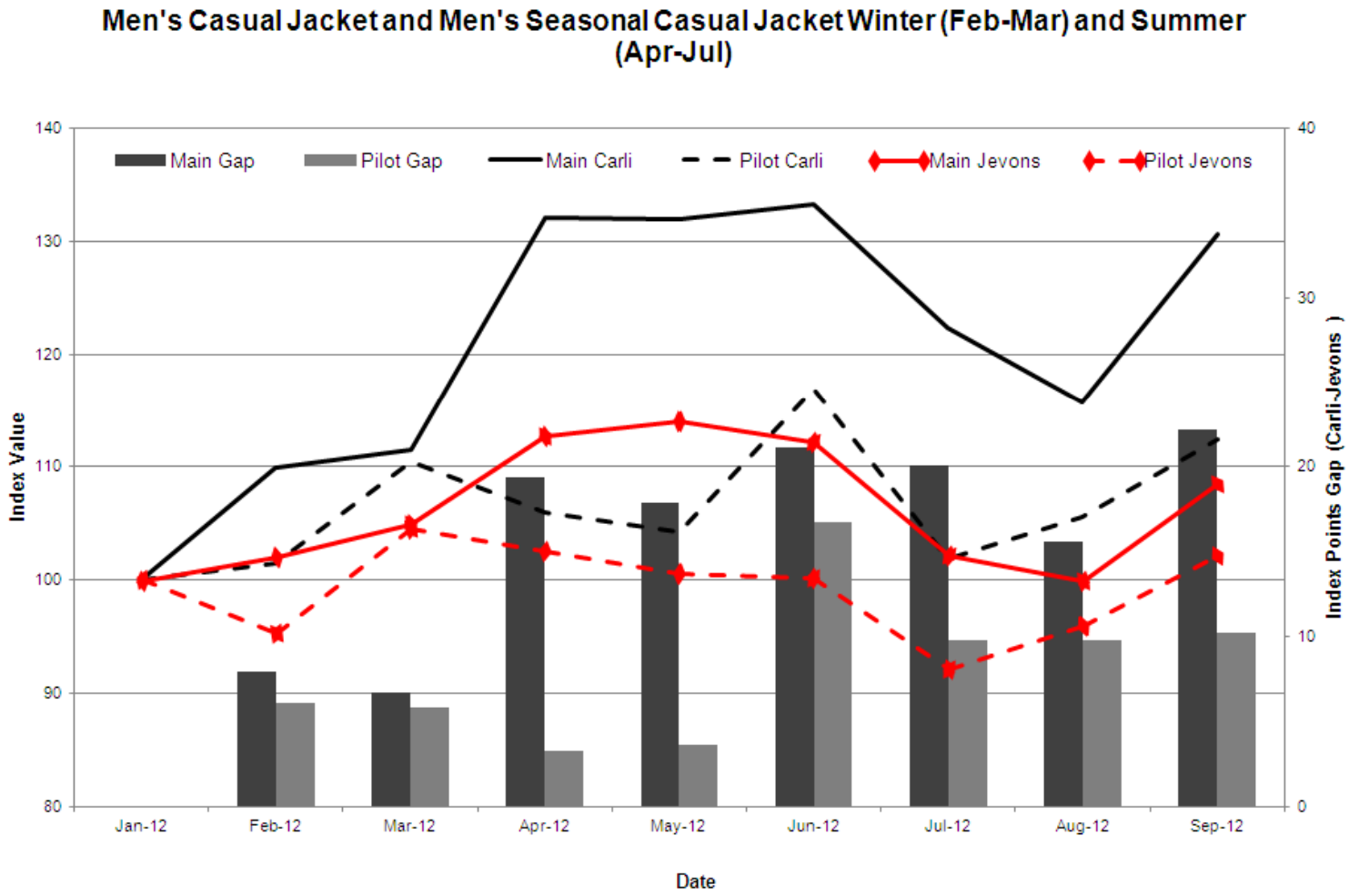
What's next?

- ONS regularly review the component parts of the RPI and CPI
- October 2012 consultation suggested:
  - Major change to formula
    - Outcome was for no change to formula
    - But continued revision in data collection
  - Change to data sources for rented private housing
- June 2012 consultation considered how to include housing in CPI
  - From March 2013 CPIH will reflect owner occupied housing costs using 'rental equivalence'
  - RPI uses a 'payments' approach that allows for mortgage interest payments
- If statutory rate of increase has to reflect the 'increase in the general level of prices' could this be CPIH?
  - But ONS expects CPIH ≈ CPI

What's next?

	CPI	CPIH	RPIJ	RPI
February 2013	2.8	2.6	2.7	3.2
March 2013	2.8	2.6	2.6	3.3

What's next?



Source: National Statistician's Consumer Prices Advisory Committee, Update on the clothing pilot price collection. Jan 2013



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