

ANNEX: THE NEW INFLATION TARGET

The new inflation target and the monetary policy framework

Following his announcement on 9 June 2003, the Chancellor has confirmed that the new inflation target will be based on the harmonised index of consumer prices. The National Statistician has named the index the Consumer Prices Index or CPI in the United Kingdom. The Chancellor has decided that, from today, the new inflation target will be 2 per cent for the 12-month increase in the CPI. The rate for the new target is $\frac{1}{2}$ a percentage point lower than the old target because of differences in the way that CPI and Retail Prices Index excluding mortgage interest payments (RPIX) inflation are measured. The level of the new target is set to be consistent with the old target in two years' time, the typical forecast horizon for monetary policy purposes, and broadly in line with the expected long-run difference between the CPI and RPIX measures arising from differences between their formulae.

2. The change is made in accordance with the framework for monetary policy introduced in 1997, when the Monetary Policy Committee (MPC) of the Bank of England was established to set interest rates to meet the Government's inflation target. All other aspects of the framework will remain unchanged. Under the monetary policy framework, if inflation moves by more than 1 percentage point above or below the target, an open letter will be triggered from the Governor of the Bank of England to the Chancellor. The open letter would explain the reasons for the deviation of inflation from the target, the policy action that would be taken to deal with this deviation, the period within which inflation would be expected to return to target, and how the approach met the Government's monetary policy objectives.

3. Furthermore, as stated by the Chancellor on 9 June 2003, pensions, benefits and index-linked gilts will be calculated on exactly the same basis as now. In addition, the RPI, or where applicable its derivative indices, will continue to be used for the indexation of benefits, tax credits and tax allowances. The Government will continue to issue gilts linked to the RPI measure of inflation.

Moving from RPIX to CPI

4. Since the inception of the MPC, the Government's inflation target has been based on a symmetric inflation target for the 12-month increase in the RPIX of $2\frac{1}{2}$ per cent. This system has served us well. But it is important that monetary policy decisions are based on the most relevant and accurate measure of inflation for this purpose. The Retail Prices Index (RPI), and hence RPIX, have long been designed to meet a variety of needs. This has necessitated some long-standing compromises in conceptual consistency. Further detail about the CPI, including the advantages for monetary policy

purposes, are set out in more detail in the paper by the Office for National Statistics (ONS) 'The New Inflation Target: the Statistical Perspective' published on 10 December 2003. The paper states that: 'In the last decade, a global consensus has begun to emerge about the desirable form of consumer price indices appropriate for measuring inflation at a macroeconomic level. This consensus has helped shape the CPI during its development, meaning that it has some distinct advantages over RPIX as a macroeconomic indicator of inflation, partly reflecting the fact that the latter was not developed specifically for this single purpose'.

5. The CPI is a measure of the general level of prices charged for consumer goods and services. In common with the RPIX, a large range of prices are weighted together according to the pattern of households' expenditure and changes over time are calculated by weighting the proportional change in individual prices by their shares in total expenditure. Changes across adjacent 12-month periods are chain-linked by adjusting the weights annually to reflect changes in the pattern of consumers' expenditure. To improve the comparison of inflation across EU Member States, Eurostat, in conjunction with Member States, introduced a harmonised measure of inflation for all EU countries on a common basis, known as the Harmonised Index of Consumer Prices (HICP). It is constructed in accordance with a European Council Regulation passed in October 1995 and a subsequent series of Regulations and Guidelines. HICPs for each EU Member State have been developed by the Statistical Offices of the Member States, under the direction of Eurostat, the Statistical Office of the European Community. The ONS first published UK inflation on a CPI (then called HICP) basis in February 1997¹ to complement existing indices such as the RPI. In 1998, the ONS constructed an extended historical series of data for the CPI². Since February 1999, CPI inflation has been published by the ONS alongside the RPI and RPIX.

Differences between the CPI and the RPIX

6. The CPI is calculated from the same raw price data as the RPI and RPIX. There are, however, a number of methodological and coverage differences between the RPIX and CPI that lead to divergences in the inflation rates. These differences can be divided into differences in formulae and coverage.

¹ Further description is provided in ONS' articles in Economic Trends in: March 1998, December 1998, March 2000, March 2001 and March 2002.

² Indicative inflation rates were calculated for the period from 1976 to 1989. These are not based on the original price quotations, although coverage differences were allowed for. The indicative CPI inflation rates are based on an assumed geometric mean effect of 0.25 percentage points prior to 1989. A summary analysis was reported in a Pre-Budget Report publication by HM Treasury "The Harmonised Index of Consumer Prices (HICP): Some Factual Information" in November 1998.

The formula effect

7. The formula effect arises because individual prices in the CPI are aggregated within each expenditure category by taking the geometric mean rather than the use of arithmetic means in the RPIX. The geometric mean implicitly allows for the substitution of cheaper goods for more expensive goods when their relative prices change whereas, under the arithmetic mean, the quantity of each good remains the same irrespective of price changes.

The coverage effect

8. The RPIX and CPI include different items, giving rise to a coverage effect. In particular, the RPIX includes seven components of housing costs – housing depreciation, council tax, dwellings insurance, ground rent, estate agents' fees, surveyors' costs and conveyancing fees – which have a weight of 9.5 per cent in the RPIX but which are not included in the CPI. Other coverage differences are the inclusion of university accommodation fees, foreign students' university tuition fees and unit trust and stockbroker charges in the CPI but not the RPIX, the use of different expenditure weights in the CPI and the use of alternative methodological treatments for some components.

9. The exclusion of certain housing cost elements from the CPI does not mean that housing developments will not be an important factor for monetary policy purposes or that house prices will be more volatile under a CPI-based target. Although the MPC will target CPI inflation, house prices are – and will continue to be – an important indicator in assessing macroeconomic developments for monetary policy. Furthermore, as discussed in detail in the ONS's paper published today, Eurostat is currently undertaking a pilot study (in which the UK is participating) to assess the preferred means of incorporating a measure of housing costs into the CPI. The ONS is expected to take into account any internationally agreed future changes in the measurement of inflation. Benefits will continue to be up-rated by the RPI, or derivative indices, as now. Recipients will continue to receive assistance with housing costs through the housing costs element of the RPI or through help for housing costs targeted at low-income households³.

10. Since 1997 (when the ONS first published the CPI):

- the formula effect has been relatively stable and contributed around $\frac{1}{2}$ a percentage point, on average, to the gap between CPI and RPIX inflation;
- high growth in house prices since 1997 has caused the difference between RPIX and CPI inflation to increase. The effect of housing costs has been to contribute around $\frac{1}{2}$ a

³ Housing Benefit, Council Tax Benefit and Income Support for Mortgage Interest are available to help low income households with housing costs.

percentage point, on average, to the gap between CPI and RPIX inflation. However, house price inflation at these rates is unlikely to continue; and

- other (non-housing) coverage effects have, on average, been close to zero.

Forecasts of CPI and RPIX inflation

11. The difference between CPI and RPIX inflation is expected to narrow markedly from 1.3 percentage points in October 2003 to $\frac{1}{2}$ a percentage point two years ahead, the typical forecast horizon for monetary policy purposes. Thereafter, the differential is expected to remain broadly stable, rising slightly above $\frac{1}{2}$ a percentage point in future years depending on a range of economic factors. The ONS is expected to take into account any internationally agreed future changes in the measurement of inflation.

The advantages of the CPI measure of inflation for the inflation target

12. The move to a target for inflation based on the CPI measure of inflation has a number of distinct advantages over the RPIX measure for monetary policy purposes. The ONS considers the relative strengths and weakness of the CPI compared with the RPIX in its paper published today. The main advantages can be summarised as follows:

- the CPI better allows for the substitution of cheaper for more expensive goods and services within expenditure categories when relative prices change and so may be considered a more realistic depiction of consumer behaviour;
- the CPI has a wider population coverage and is more consistent with national accounts principles of consumer expenditure, so it shares a coherence with other economic statistics and gives a better picture of spending patterns in the UK; and
- the CPI is a more comparable measure of inflation internationally and represents international best practice.

Conclusion

13. In accordance with the Bank of England Act (1998), the Chancellor has decided to change the inflation target, from today, to the CPI measure of inflation. The new inflation target will be set at 2 per cent for the 12-month increase in the CPI. The trigger points for the open letter will remain at 1 percentage point either side of the new target.

14. The rate for the new target is $\frac{1}{2}$ a percentage point lower than the old target. The gap reflects the differences in the way that CPI and RPIX inflation are measured, notably the formula effect, which means that CPI inflation tends to be lower than RPIX inflation on average. The level of the new target is set to be consistent with the previous target in two years' time, that is, the typical forecast horizon for monetary policy purposes.

**HM Treasury
December 2003**

