BANK OF ENGLAND

Stephen Penneck
Chair, RSS National Statistics Advisory Group
Royal Statistical Society
12 Errol Street
London
EC1Y 8LX

Ben Broadbent
Deputy Governor, Monetary Policy

8 November 2018

Dear Mr Penneck

Many thanks for your letter dated 29 October 2018 regarding the House of Lords Economic Affairs Committee's inquiry into the Retail Prices Index (RPI), in which you raised some points regarding the testimony I gave on 9 October.

As I set out in my evidence, I think the Consumer Prices Index is the most theoretically coherent, reliable, and accurate measure of inflation we have for measuring the change in consumer prices. It is based on the fundamental and internationally agreed definition of consumption. There is no evidence to suggest it under-estimates inflation (in that respect, I agree with the conclusions of Paul Johnson's *Review, https://www.statisticsauthority.gov.uk/archive/reports---correspondence/current-reviews/uk-consumer-price-statistics---a-review.pdf* and in particular, his view that when no expenditure weights are available, the choice of aggregation method cannot be determined by views about the appropriateness of allowing for substitution behaviour.) Nor do I believe there is any longer much "debate" about the failings of the Carli aggregation method. Fisher was pretty clear in his criticisms of Carli in 1922: "if this book has no other effect than to lead to the total abandonment of the simple arithmetic type of index number it will have served a useful purpose". Almost a century later there is virtually no other statistical agency in an advanced economy that uses it.

Of course, as with any statistic, the CPI can always be improved, and the ONS has embarked on a comprehensive plan for its continuous development. An example is the incorporation of owner occupiers' housing costs, now included in the CPIH index. But conceptually, the CPI is founded on theoretically coherent and internationally recognised principles for a consumer price index, and uses sound implementation methods.

The conceptual foundation of the Household Costs Indices is less clear. If, as you say, receipts of interest or any other asset return are "of course" income, then it must be the case that interest payments are "of course" deductions from income. Certainly neither should be seen as consumption. This is, by definition, spending on current goods and services and does not include gross flows of asset income, whether positive or negative. (As it happens I don't think this definition is just a quirk of the National Accounts or the preserve of "professional economists"; it's more fundamental than that.) But it's also a simple matter of consistency. If receipts of asset returns are income, then payments of interest must equivalently count as deductions from income. Too often, it seems to me, the phrase “household experience” is used selectively to describe changes in particular flows of funds that are clearly not consumption. What homeowners consume are the housing services provided by their home. The price of these services is independent, and should be measured independently, of the means by which the purchase of the home is financed. If I buy something at a shop I may end up paying more for that decision if I’ve funded the purchase with a consumer loan rather than with cash. But the price of the good is the same either way, and one shouldn’t confuse the two.

That is one reason why, incidentally, the RPI measure of owner-occupation costs makes little sense. A cash buyer of a property pays the same price as anyone else and continues thereafter to consume, and implicitly to pay for, the identical housing services it provides. So the mortgage interest rate cannot be the right way to measure such costs. Those should be invariant to the means by which the services are financed. (As I explained to the select committee, the EU has not incorporated owner-occupiers’ housing costs, however measured, into the Harmonised Index of Consumer Prices. You can find more information on the regulation that governs the HICP here https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32016R0792.)

To be fair to the ONS it takes care to emphasise that its HCIs are not price indices and that they are not intended to measure the cost of consumption. It also publishes a wealth of information about flows of mortgage payments and other receipts and payments on financial assets and liabilities. It’s also the case that, on occasion, there will be interest in prices facing different groups of households, according to their particular consumption basket. The ONS already provides versions of the CPIH for different socio-economic groups. There may also be a case for exploring the use of what are sometimes called “democratic” as opposed to “plutocratic” weights or other ways to represent the experience of the median (rather than the mean) household. However, I don’t think these should be presented as “national” indices. Nor should HCIs be presented as price indices.

I trust you find my reply to your letter helpful. You may be interested in the Bank of England’s technical advice on the development of the Household Costs Indices, provided in response to the ONS consultation concluded in 2017, available here.
https://www.ons.gov.uk/economy/inflationandpriceindices/methodologies/developinganindexofhouseholdpaymentsfullresponsesfeb2017.

We will, as always, continue to engage with the ONS and other stakeholders, including members of the RSS, via the usual stakeholder panels, and other inclusive fora, regarding the future development of consumer price statistics.

I am copying this letter to the Clerk of the House of Lords Economic Affairs Committee and the National Statistician, John Pullinger.

Yours sincerely

Ben Broadbent