

[REDACTED]@h
mtreasury.gsi.gov.u
k

16/10/2012 18:09

To Richard Campbell/NEWPORT/ONS@ONS, [REDACTED]
[REDACTED], Derek
Bird/EEPDP/BSG/NEWPORT/ONS@ONS

cc

Subject [RESTRICATED] RE: - Re: UK Comment: CPAC consultation:
t only option 2 lets the RPI fulfill its purpose

Richard,

We will provide something ahead of the consultation meeting on the 26th.

[REDACTED]

HM Treasury, [REDACTED]

From: Richard Campbell [REDACTED]@ons.gsi.gov.uk]

Sent: 11 October 2012 15:14

To: [REDACTED] HMT

Cc: [REDACTED] Derek Bird; [REDACTED]

[REDACTED]@bankofengland.gsi.gov.uk; [REDACTED]

Subject: [RESTRICATED] - Re: UK Comment: CPAC consultation: only option 2 lets the RPI fulfill its purpose

[REDACTED] that would be great thanks.

Richard Campbell

[REDACTED]

Office for National Statistics

[REDACTED]

[REDACTED]@hmt
reasury.gsi.gov.uk

11/10/2012 14:36

To: [REDACTED]@bankofengland.gsi.gov.uk, Derek
Bird/EEPD/BSG/NEWPORT/ONS@ONS, [REDACTED], Richard
Campbell/NEWPORT/ONS@ONS

[REDACTED]
Subject: [REDACTED] RE: UK Comment: CPAC consultation: only option 2 lets the RPI fulfill its
purpose
ct

Yes, we've been following market comment quite closely and would be happy to share our updated note on comment along with specific notes if that would be helpful.

Thanks

[REDACTED]

From: [REDACTED]
[REDACTED] [\[REDACTED\]@bankofengland.gsi.gov.uk](mailto:[REDACTED]@bankofengland.gsi.gov.uk)
Sent: 11 October 2012 14:15
To: 'Derek Bird'; [REDACTED] 'Richard Campbell'
Cc: [REDACTED] HMT; [REDACTED] HMT
Subject: FW: UK Comment: CPAC consultation: only option 2 lets the RPI fulfill its purpose

Hello all,

I just wondered whether you'd picked up on some of the market talk on this two date. These are, of course, but two opinions.

[REDACTED]

[REDACTED]

The ONS consultation is considering four options:

1. No change
2. Replace the Carli formula for clothing only
3. Replace all instances of the Carli formula
4. Remove the whole formula effect

• [REDACTED]

[REDACTED]

- The potential changes to RPI had been most significant for pricing at the short-end of the curve, where inflation valuations are more important (rather than the liability hedging focus at the long-end). Breakeven inflation rates out to 15 years were consistent with the removal of the full formula effect and a 30 basis points RPI-CPI wedge (to account for factors such as housing).

From: [REDACTED]
Sent: Wednesday, October 10, 2012 11:49 AM
To: [REDACTED]
Subject: UK Comment: CPAC consultation: only option 2 lets the RPI fulfill its purpose

This email has reached the Bank via the Internet or an external network

[REDACTED]	
------------	--

CPAC consultation: only option 2 lets the RPI fulfill its purpose
- In response to the consultation on the RPI, we state a preference for option 2, which would subtract 40-45bp from the formula effect and RPI. It is the only option that would ensure the RPI meets its ultimate purpose. However, pure statistical reasons still make option 3 highly likely. That would subtract about 70bp from RPI inflation instead.

The ONS launched a consultation of users as part of its review into the "formula effect". It presented four options for reform of the formulae used to aggregate prices at the lowest level (e.g. the average bread price). We do not dispute the statistical facts put forward as part of the review, but in our response we aim to emphasise the importance of the RPI meeting its purpose. The Carli formula is clearly suboptimal, but the bias in it is relatively stable. As such, it has been reliably incorporated into the users' understanding of the RPI. For anyone that can immediately adjust the spread in their link to the RPI, the change makes no difference. When that is not true, the RPI will fail to meet its purpose for the rest of the contracted link. In wage settlements that means a few years, but in the inflation-linked gilts market, that can mean decades. So we encourage the ONS not to become statistical

vigilantes that forsake the users that lend purpose to the very existence of the RPI. Only option 2 would approximately unwind the spurious rise in the formula effect and thus RPI inflation since January 2010. Option 3 or 4 would be a statistical default for the government, and could adversely affect market perceptions of the sovereign.

While option 2 is our preference, we continue to see a significant probability that option 3 is selected instead. That would subtract about 70bp from the formula effect, versus 40-45bp for option 2. On the upside, the statistically flawed Carli index would be removed, but at the cost of fundamentally changing the RPI so that it no longer corresponds to what users had in good faith considered it to be. Our forecasts continue to factor in a compression in the formula effect over the course of 2013 to 30bp, which is the midpoint of the 40-20bp range that we expect option 2 or option 3 would cause respectively. Because we assume the CPI inflation target will still be slightly missed in the long run at an average 2.2% y-o-y (see [UK Theme: Inflation in a black hole](#)), this leads us to expect an average long-run RPI inflation rate of 2.75%-2.55%. Selection of one of the extreme options would cause an average of 3.15% or 2.35%, in our view.

The options are:

- 1) No change
- 2) Change formula used for clothing (Carli to either Dutot or Jevons)
- 3) Remove all Carli formula (for either Dutot or Jevons)
- 4) Align all formulae in the RPI with those in the CPI



What are the methodological considerations behind your preference?

Central to our preference is the knowledge that summary statistics like the RPI only exist to serve a purpose and thus changes must be weighed up against the achievement of that purpose. Obviously the RPI, with all its associated methodological characteristics, was taken in good faith and applied to a variety of purposes. Prior to January 2010, the formula effect was well understood and fairly stable, so it could reliably be factored into anyone's expectations for RPI inflation, with fixed spreads often used to make it suitable for the application at hand.

A permanent level shift to the formula effect and thus the inflation rate would affect anyone that had put their faith in the RPI. If sufficient confidence remains in the RPI for current users to keep it as their benchmark, whatever spread they are applying relative to the RPI can be adjusted to keep it fit for purpose. Once this is done, there is essentially no difference, other than in the statistical derivation. It would continue to meet the intended purpose. The trouble comes when frictions prevent an immediate adjustment in the spread. And the associated cost grows with the length of the RPI-linked commitment.

One of the main purposes of the RPI is to serve as a benchmark for the inflation-linked gilt market. The average maturity here is 22.5 years. That is a long-time for an investor to lick their wounds caused by mistakenly trusting the RPI (although in reality the pain is front-loaded with the fall in market price). Expectations can be adjusted for the price of new issuance, making neither government nor investor necessarily worse off. But legacy holders face a possible statistical default, which is not something the UK should follow the Argentinean example in doing.

We believe some action is needed to reverse the rise in RPI inflation brought about by previous methodological changes. Most investors did not factor this past rise into their expectations, so it has not distorted the issuance price. However, it has provided a surprise dividend to legacy holders over the past few years and the justification for allowing it to persist is weak. So our preference is for option 2, which would leave the Carli index in partial use, despite its persistent flaws. By subtracting 40-45bp from RPI inflation, this option would still succeed in returning the formula effect to roughly the level that it was understood to be when faith was placed in the RPI. Combined with the several basis point contribution to the CPI-RPI basis caused by harmonising the measurement of car prices, RPI inflation itself would become almost exactly what it was historically viewed to be again. Only the composition of the basis would be slightly different and the statistical properties slightly better. In essence, option 2 would cancel a previous social welfare loss, no more, no less. Option 3 or 4 would cancel the social

welfare loss, but would also impose a new and larger private welfare loss. That is because the instability would cause the RPI to fail in its purpose for current users, even if it became "better" statistically speaking.

As for the choice between Dutot and Jevons, this is not something we have such a strong opinion on. However, we would lean slightly in favour of the Dutot in the interests of consistency with the rest of the RPI. Its failing of the "changes in the units of measurement test" is not really an issue for clothing. Avoiding partial usage of Jevons may dampen costly concerns that the future may see all legacy Dutot usage switched to Jevons in the RPI.

In conclusion, we strongly favour option 2 as only this would allow the RPI to fulfil the purpose most users placed their trust and money in. The absolute level of the formula effect does not matter, so long as it is understood and appropriately factored in whenever the RPI is linked to. Selecting option 2 would ensure that is the case. Option 3 and especially option 4 would punish users in the transition to what might be a better index in statistical terms (albeit to no real gain if the gap is stable, and statistical benefit is questionable in the case of option 4), but would cause the RPI to fail current users in its ultimate purpose. So we implore the CPAC not to become statistical vigilantes that forsake the users that lend purpose to the very existence of the RPI.

Do the options for improving the RPI have any impacts you would like to make the National Statistician aware of?

There are adverse market impacts to consider:

- Most market participants would view option 4 as a covert default, dampening their willingness to participate in the UK government bond market at a time when high demand is crucial to absorbing the issuance needed to fund the government's large fiscal deficit. Any savings on interest payments may be more than offset by reputational damage.
- Investors holding long and ultra long maturity bonds often do so to hedge their long-term liabilities (e.g. pensions). Because these liabilities would also be reduced by the RPI change, such holders would not necessarily be adversely affected (liabilities are typically under-hedged). However, other investors would find their holdings (e.g. of 10yr etc) worth much less and lose out disproportionately. This could cause a perception that the statistical default is on external debt, which is damaging to the UK's global reputation. In market terms, these reforms cause an arbitrary distortion in the market that flattens the real yield curve.
- It would be difficult for the BoE to credibly argue that either option 3 or 4 do not adversely affect holders of inflation-linked gilts. If then implemented, redemption clauses in the old 8-month lag linkers (except 35s) come into play, but at current prices the loss would be so large that triggering the so-called legal protection would be uneconomic. Proving "protection" worthless is damaging to the UK's reputation for creditworthiness.
- Any decision must be accompanied by clear and forceful guidance on possible changes in the future. If not, linkers may cheapen from "methodology" (negative) premium as investors demand a higher real yield to compensate themselves for the possibility of a statistical default in the future. Although this would not be an issue for option 4, the extra pain it would cause means that is not a good reason to choose that option.

Do you support the proposal to change the source for the data for private housing rental prices?

Yes. The significant enlargement in sample size (from 1.2k to 800k) would make this series more representative of reality and make the change worthwhile. Although the annual rate would have been slightly stronger in the past, it is not clear that differences of this magnitude would persist in the future. The 4bp widening in the CPI-RPI basis (at peak inflation uplift) might complicate perceptions of the gap between the two indices inflation rate. But the magnitude pales in comparison with the proposed changes in the formula effect. Because this rental change would normally act in the opposite direction to the formula effect change, the case for its implementation would strengthen further if the more extreme options (3 or 4) are implemented.

If on behalf of an organisation, please state how the views of the members were assembled:

Discussions were held between our economics and inflation strategy teams, as they have been throughout our coverage of this potential change to the formula effect. Our response is the independent research opinion of the firm and is being published separately as such. We provide our opinion without any knowledge or prejudice derived from the firm's holdings of inflation-linked gilts.

[REDACTED]

The text above is a synopsis and is not a substitute for the complete document. For analyst certifications and important disclosures, please see the final page(s) of the complete document.

To read 'UK Comment: CPAC consultation: only option 2 lets the RPI fulfill its purpose', please click on the URL below.

[Click Here To Retrieve Document](#)

[Disclosure information is available at www.nomuranow.com/research/globalresearchportal](http://www.nomuranow.com/research/globalresearchportal)

This e-mail (including any attachments) is confidential, may contain proprietary or privileged information and is intended for the named recipient(s) only. Unintended recipients are prohibited from taking action on the basis of information in this e-mail and must delete all copies.

Nomura will not accept responsibility or liability for the accuracy or completeness of, or the presence of any virus or disabling code in, this e-mail. If verification is sought please request a hard copy. Any reference to the terms of executed transactions should be treated as preliminary only and subject to formal written confirmation by Nomura. Nomura reserves the right to monitor e-mail communications through its networks (in accordance with applicable laws). No confidentiality or privilege is waived or lost by Nomura by any mistransmission of this e-mail. Any reference to "Nomura" is a reference to any entity in the Nomura Holdings, Inc. group. Please read our Electronic Communications Legal Notice which forms part of this e-mail: http://www.Nomura.com/email_disclaimer.htm

This e-mail originated from the Internet and has been scanned for known viruses by the Messagelabs SkyScan Service.

This e-mail is intended for the addressee(s) named above and any other use is prohibited. It may contain confidential information. If you received this e-mail in error please contact the sender by return e-mail.

The Bank of England does not accept legal responsibility for the contents of this message if it has reached you via the Internet, as Internet communications are not secure. Any opinions expressed are those of the author and are not necessarily endorsed by the Bank of England.

Recipients are advised to apply their own virus checks to this message .

This email and any files transmitted with it are intended solely for the use of the individual(s) to whom they are addressed. If you are not the intended recipient and have received this email in error, please notify the sender and delete the email.