Economics Seminar, Indian Statistical Institute, New Delhi

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TITLE: A Policy-Sensible Benchmark Core Inflation Measure. An Application to Euro Area and US Data

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ABSTRACT

Core -or underlying- inflation indicators feature prominently in the economic debate and in central banks' external communication and internal policy discussions. Notwithstanding their popularity, whether core inflation measures should play a role in the monetary policy-making process is questionable. Indeed, most of them are based exclusively on statistical criteria and, as a consequence, a firm theoretical justification is generally lacking; furthermore, their usefulness for policy-making purposes is not firmly established. In this paper, we propose an approach to build a benchmark measure of core inflation that aims at overcoming the latter limitation directly and may thus be used to appraise the merits of existing popular core inflation indicators. Specifically, our benchmark measure is derived on the basis of a criterion that explicitly treats core inflation as an artificial concept whose usefulness rests with its being helpful to improving monetary policy effectiveness. Using that measure - built on the basis of the solution to a standard optimal monetary policy problem- as a yardstick, the performance and policy usefulness of other, popular core inflation indicators may be appraised. The approach is illustrated by means of an application to euro area and US data. For the euro area, the under-performance of exclusion core inflation indicators is generally limited, with the exception of the case in which inflation is the monetary policymaker overriding concern; other underlying inflation measures, by contrast, perform rather poorly. For the US, exclusion core inflation indicators fare systematically well compared with the benchmark; however, the welfare performance of monetary policy would not sensibly deteriorate if the policymaker was to rely on a standard monetary policy reaction function.