

### Box 1 Different measures of core inflation

The joint declaration by the Government of Iceland and the Central Bank of Iceland from March 27, 2001 on an inflation target and a change in the exchange rate policy, states that the Central Bank, in consultation with Statistics Iceland, will construct one or more measure of underlying inflation, which the Bank could use in the implementation of monetary policy. This task has now been completed and, starting with the publication of the Consumer Price Index (CPI) on November 12 this year, Statistics Iceland will publish two new indices, Core Index 1 and Core Index 2. Both are compiled on the same basis as the CPI, with the former excluding prices of vegetables, fruit, agricultural products and petrol, and the other also excluding the prices of public services. Other measures of core inflation, correcting for effects of indirect taxes and subsidies, may also be published at a later date. Such indices would be of unquestionable benefit, but would require a considerable amount of preparatory work and methodological studies.

The components excluded from the two core indices are either volatile, more or less beyond the

impact of monetary policy, or reflect relative price changes that are normally undesirable for monetary policy to react to. An article by Thórarinn G. Pétursson elsewhere in the Bulletin discusses the arguments for using measures of core inflation in monetary policy formulation, and viewpoints on their compilation. In the Central Bank's view, using these core inflation measures with the headline CPI measure in the formulation of monetary policy will facilitate it in explaining its policy measures to the government and the general public. Furthermore, they ought to help in anchoring inflation expectations more closely to the underlying inflation trend rather than short-lived price changes. This can reduce fluctuations in output and the policy interest rate which may result from too rigorous a stance by the Bank to keep inflation on target.

It should, however, be underlined that calculation of the core indices does not change the fact that the CPI will remain the formal criterion for the Central Bank's inflation target.