BANK OF ENGLAND

News release

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

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A New Measure of 'Core Inflation in the UK' MPC Unit Discussion Paper No 3 By Joanne Cutler

The MPC Unit has published Discussion Paper No. 3 on the Bank of England's website today. The research was commissioned by Dr DeAnne Julius, Member of the Monetary Policy Committee, and addresses the usefulness of measures of core inflation.

The paper presents a new measure of core inflation for the United Kingdom. This is based on the same goods and services used in the measurement of RPIX inflation, weighted by the persistence of their past inflation rates to derive a persistence-based measure of retail price inflation, or RPIXP for short.

The new measure suggests that disinflationary pressures were more intense in the UK during the second half of the 1990s.

The research finds that RPIXP can be a useful leading indicator of RPIX inflation. It suggests that underlying inflation was just 1.2% in February and that RPIX will remain below its target level of 2.5% for at least the next 6 to 12 months. A summary of the paper is attached.

Note to Editors

The External MPC Unit Discussion Paper series reports on research carried out by, or under supervision of, the External Members of the Monetary Policy Committee and their dedicated economic staff. Papers are made available as soon as practicable in order to share research results and stimulate further discussion of key policy issues. The views expressed are those of the author(s) and do not represent the views of the Bank of England or necessarily the views of External Members of the Monetary Policy Committee.

Summary

Many central banks use core inflation measures in setting monetary policy. These measures attempt to strip out erratic movements in headline measures of inflation to provide a better gauge of underlying inflation.

This paper presents a new measure of core inflation for the United Kingdom. This is based on the same goods and services used in the measurement of RPIX inflation, weighted by the persistence of their past inflation rates to derive a persistence-based measure of retail price inflation, or RPIXP for short. This differs from RPIX which weights individual price components by their importance in households' budgets.

The idea behind RPIXP is that, if a particular component has a very persistent inflation rate over the past, it should carry more information about the 'on-going' element of inflation and therefore help to predict future RPIX inflation. Policy makers need to form a view about future inflation when setting policy because it takes some time for changes in interest rates to affect inflation. A measure of core inflation with good predictive properties is a useful complement to a model-based inflation forecast for this purpose.

The new measure seeks to overcome a shortcoming of existing measures of core inflation. Typically, these are based on the RPIX index excluding certain sectors, like seasonal food and energy which are believed to have volatile inflation rates, or 'extreme' price changes which are not thought to be representative of generalised inflationary pressures. However, the paper argues that such measures may strip out or ignore important information about underlying inflation because they are essentially ad hoc rather than analytically based on the persistence of individual inflation rates.

The paper goes on to evaluate the new and existing core inflation measures in terms of their ability to predict future RPIX inflation. It finds that the new RPIXP is a good predictor of RPIX 6 months and 12 months ahead. It outperforms most other core inflation measures, as well as current RPIX itself, in its predictive ability.

Surprisingly, RPIX excluding food and energy, a popular way of measuring core inflation, is a poor predictor. One reason is that this measure excludes non-seasonal food prices which are highly persistent in the UK.

The movement of the new RPIXP measure over the early 1990s suggests that there was more momentum behind the inflationary pressures which built up during the late-1980s than was apparent in RPIX itself. It also suggests that disinflationary pressures were more intense in the second half of the 1990s. RPIXP has been consistently below RPIX since the Autumn of 1996. This reflects, in part, the weakness of non-seasonal food, and clothing and footwear, prices where competitive pressures were intensified by the strength of sterling, the Asian crisis and global oversupply. These items have a high weight in a persistence-based core inflation measure. By contrast, the more recent rise, and then fall, in oil prices has had very little effect on RPIXP because petrol and oil have a low weight in a persistence-based measure of core inflation.

The paper concludes that the new measure can be a useful leading indicator of RPIX inflation. RPIXP suggests that underlying inflation was just 1.2% in February and that RPIX will remain below its target level of 2.5% for at least the next 6 to 12 months.

Key Resources

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http://www.bankofengland.co.uk/archive/Documents/historicpubs/externalmpcpapers/extmpcpaper0003.pdf