



MONETARY POLICY DEPARTMENT

Methodology note on core inflation

The purpose of the core inflation calculation

The Consumer Price Index (CPI), calculated and published by INSTAT, serves to measure headline inflation. The Bank of Albania aims to achieve the headline inflation target in a medium-term horizon. But, values of headline inflation may reflect also the presence of temporary short-term factors or one-time shocks, whose effect wears off over time. Therefore, headline inflation rates reflect not only perennial factors related to aggregate demand and monetary policy. They also incorporate supply-side effects, which are independent from the monetary policy. In principle, temporary factors should not influence the inflation trend and medium-term inflation forecasts. These factors affect individual components of the consumer price index. Excluding short-term effects does not suggest “ignoring” them. It is necessary to better understand the nature of inflationary pressures and the process of inflation formation in the economy.

The inflation rate which excludes short-term, one-time shocks and supply-side shocks, is defined as core inflation. It represents the most persistent part of the inflation which is determined by the monetary policy and demand-pulling factors. It is widely used in analysis and monetary policy decision-making processes. In principle, core inflation measurements converge to the long-term inflation trend.

Central banks conduct various measurements of core inflation. The most widely used and the easiest-to-implement approach, which has a relatively high level of transparency, is the one employing the permanent exclusion. This approach implies the removal of certain basket items, which reflect high short-term volatility and whose changes are not clearly related to monetary policy shifts.



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Calculating core inflation in the case of Albania

To calculate the core inflation, we use the dataset from the CPI basket published by the INSTAT, excluding the following items:

- *Fruit and vegetables* – show high seasonality and their market prices often reflect supply-side shocks
- *Coffee, alcoholic beverages, tobacco* – are subject to excise tax
- *Payments for electricity, drinking water, medicaments, hospital services* – basket items at regulated or quasi-regulated prices;
- *Fuel/diesel* - subject to excise and price determined by international markets' conjunctures.

Once these items are excluded, the core CPI sub-basket is generated. Core inflation is then calculated based on annual, monthly or quarterly changes in the sub-basket index. The actual share of the core CPI sub-basket is around 73.3%, whereas the share of the non-core CPI sub-basket stands at 26.7%.

These shares are subject to change, depending on the annual revision of the CPI basket. Additionally, should an item be removed any of the above-stated categories, e.g. the category of items at regulated prices, it is reclassified from the non-core basket to the core basket. For any eventual change, an explanation note will be provided.