

## **Abstract**

Measures of core inflation are designed to abstract the underlying trend in inflation from the headline measure of inflation and it is considered as the component of price change related to monetary phenomena. In that regard, core inflation can be considered as an important indicator of inflation trends, which is useful for the conduct of monetary policy. The Central Bank of Sri Lanka perceives that monitoring and analysing a proper measure of long-term underlying trend inflation in Sri Lanka is imperative to conduct its monetary policy. Therefore, several attempts have been made to compile and analyse representative measures of core inflation. Recognising the need for exploring alternative measures for Sri Lanka, this paper presents a range of core inflation measures compiled using several methods. At the same time, this focuses investigating the validity of using core inflation to gauge future inflation trends and using it as a major input in the conduct of monetary policy. Different measures produce mixed results in terms of qualifying performance criteria of a representative core inflation measure raising issues on the use of core inflation as a guiding indicator. Although some measures show certain ability to forecast future path of inflation, none of the core measures does an outstanding work in predicting inflation in Sri Lanka. However, this may be attributed to issues with regard to headline inflation series and may not be entirely due to the weaknesses in core inflation measures. Hence, these results do not undermine the usefulness of core inflation for policy formulation and analytical purposes since it serves as an important variable in tracking prevailing underlying inflation and provides an explanation on the dynamics of inflation to guide monetary policy. Core inflation indicators based on alternative methods could provide Sri Lankan monetary policymakers more timely information in addition to the official measure of core inflation.

JEL Classification: E31, E47, E52, E58

Key Words: Core Inflation, Headline Inflation, Monetary Policy, Predictability