

III

INFLATION

Impact of the Euro Zone on Estonian Prices

The rate of inflation slowed down in the early summer after almost a yearlong acceleration and indicators point to the slowdown of price appreciation in both the euro zone and Estonia. The slowdown of the inflation rate is, first and foremost, supported by external factors (the drop of the fuel prices and the exchange rate of the US dollar) whereas inflation pressure remains relatively strong for food products.

The Estonian economy experienced a period of relatively steep price increase in the first half of 2001, the peak of which was probably in the second quarter (see Figure 3.1). The slowdown of the increase of consumer prices resulted mostly from developments in the euro zone (see Figure 3.2). We have to take into account that nearly 75% of Estonia's foreign trade is with the European Union countries. The slowing of world economic growth has affected exports and investments more than expected and the growth of private consumption has been smaller than predicted, as the increase of the energy and food prices has reduced real income.

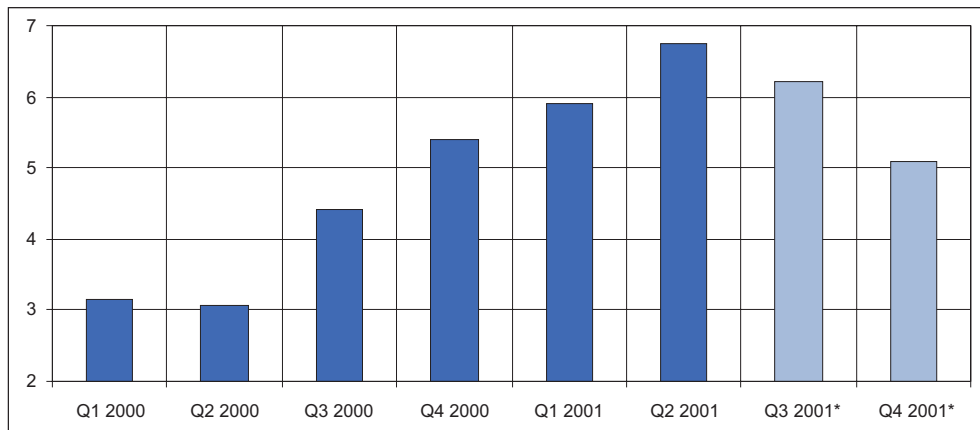


Figure 3.1. Annual growth of Estonian consumer prices (%)

* 3rd and 4th quarter of 2001 – prognosis

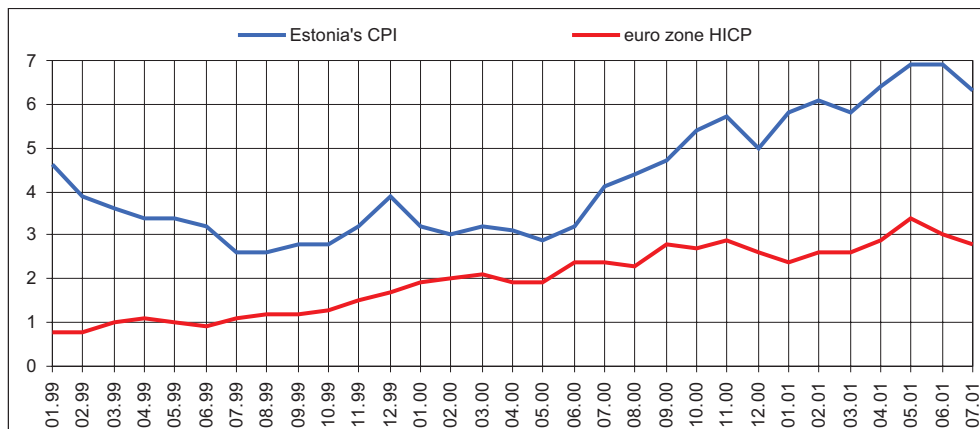


Figure 3.2. Annual growth of consumer prices in Estonia and euro zone (%)

The slowdown of the growth of external demand has slowed down the price increase in Estonia as well. At the same time, the smaller increase of consumer prices combined with other factors is expected to enliven consumption in the euro zone already in the second half of this year and next year the price increase should slow down to a long-term average also in Estonia.

Although the price increase in Estonia has been relatively high (annual 6.3% in July), there are grounds to expect a slowdown since the **latest acceleration of the inflation rate has in most part resulted from external factors of temporary nature** (increase of energy and food prices) and no considerable acceleration is expected in the rate of these price increases in the future. The annual increase of consumer prices (excluding energy, food, alcohol and tobacco) dropped to 4.1% in July. **This two-percentage-points difference against the respective figure of the euro zone is the smallest in recent history** (see Figure 3.3).

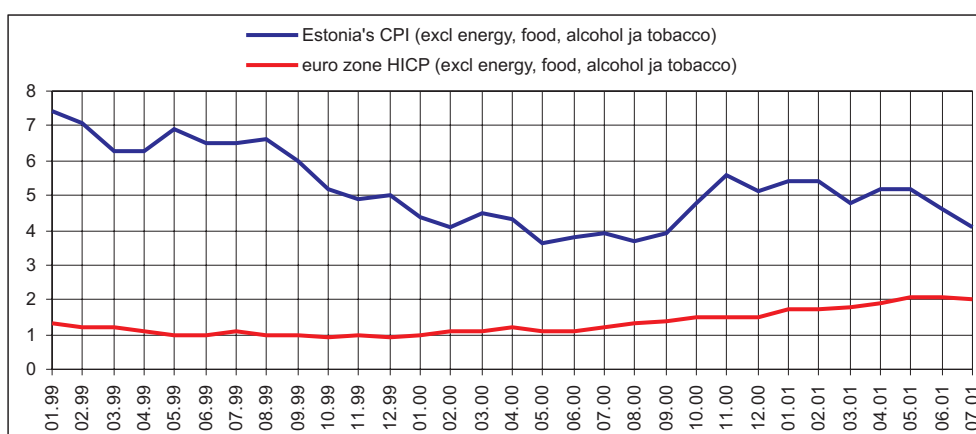


Figure 3.3. Annual growth of consumer prices in Estonia and euro zone excluding energy, food, alcohol and tobacco (%)

The appreciation of food prices has been the weightiest inflation factor in recent years and it has contributed nearly 40% of the total price increase. **In the second quarter, the acceleration of food prices stopped and in July even a slowdown was registered.** Despite the fact that the increase of food prices is currently rapid both in Estonia and the euro zone, the pressure of the recent years on the food market is easing and, thus, the increase of food prices could slow down in the second half of the year (see Figure 3.4).

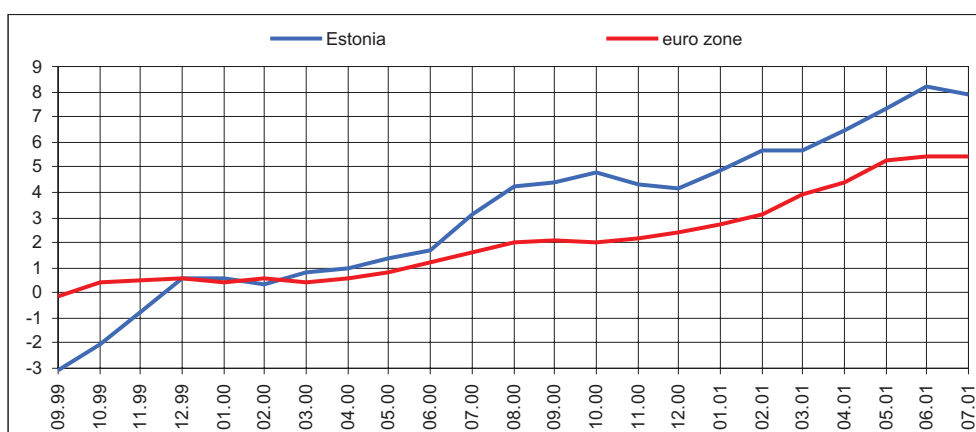


Figure 3.4. Appreciation of foodstuffs (food, alcohol, tobacco) in Estonia and euro zone (%)

Another important external factor recently has been the impact of growing energy prices (first of all, oil). In two years, the price of crude oil tripled (at the end of 2000 oil cost 34.5 euro a

barrel), then the price increase stopped and in 2001 prices have been in the range of 30±2 euro a barrel, with a decline continuing in June and July and reaching 29.4 euro a barrel. **In Estonia, the acceleration of energy prices dropped by 1.8 percentage points in two months** (from 10.7%-10.8% in May-June to 9.0% in July), although the continued high increase in fuel and food prices is an important cause of the relatively high inflation level. In the near future, the price of fuel is not expected to fall smoothly from month to month and the inflationary effect of the fuel prices is not about to disappear.

The growth of the prices of services on the domestic market is also slowing down. The acceleration of administered prices, which reached the level of a period two years ago in the first half of 2001, slowed down in June-July. Combined with the constant slowdown of the non-administered prices of the sheltered sector, it has had a stabilizing effect on price increases and has even reduced the rate (see Figure 3.5).

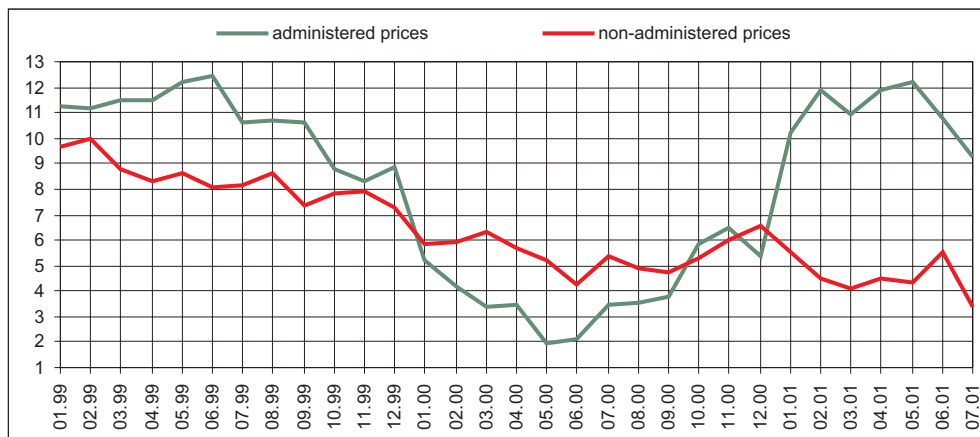


Figure 3.5. Change of twelve-month price indices of the sheltered sector (%)

In conclusion, the rate of consumer price increases is expected to slow down in the second half of this year and in 2002. This slowdown is expected to be relatively steady, although temporary deviations are possible.

As Estonia has the role of a price taker on the world market, changes in external prices are expected to have an impact on the Estonian producer prices. Therefore, the decrease in one of the most important indicators of the euro zone – the industrial producer price index – will slow down the increase of the producer prices in Estonia as well. An important role here belongs to the slowdown of the inflation rate imported with energy (see Figure 3.6).

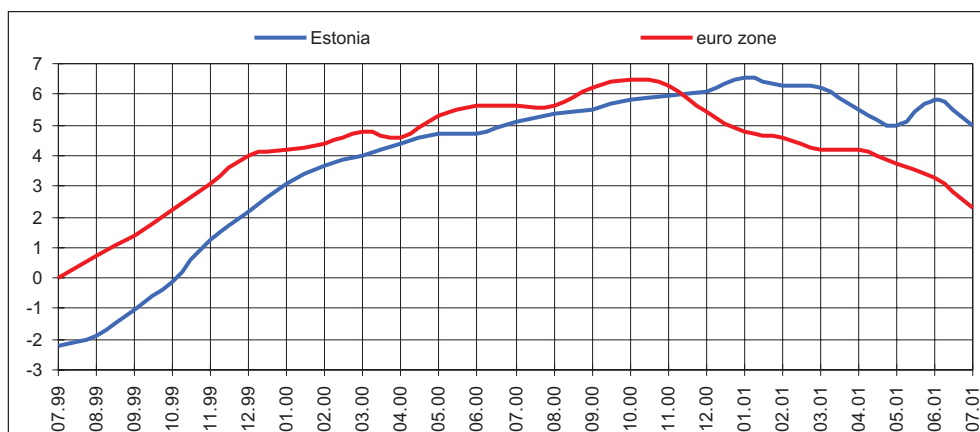


Figure 3.6. Annual growth of industrial production's producer prices (%)

Real Exchange Rate of the Kroon

Although the price level of Latvia and Lithuania as expressed in kroons is higher than that of Estonia, the price increase in those countries has not been considerably lower. The only difference is that the real exchange rate of the Estonian kroon fluctuates against the euro only due to inflation, whereas the Latvian lats and the Lithuanian litas appreciate due to inflation as well as changes in the nominal exchange rate (see Figure 3.7).

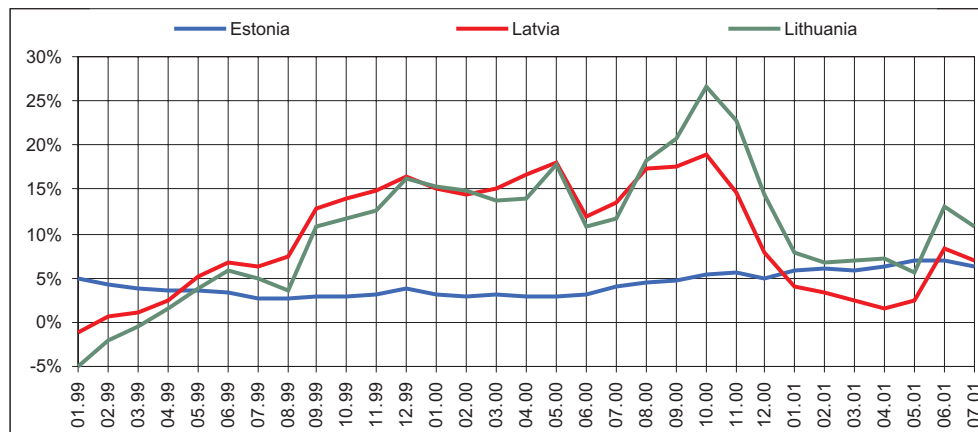


Figure 3.7. Annual growth of consumer prices expressed in Estonian kroons