

III

INFLATION

Stabilisation of the Price Increase

After the peaking of inflation in the summer of 2001, the following slowdown was expected and corresponded to external developments. The most widely used inflation indicator – the growth of consumer prices – decreased to the long-term equilibrium level in the fourth quarter, exceeding the corresponding indicator of the euro area by 2.2 percentage points. The development in early 2002 also indicated the **stabilisation of inflation rates at a level allowing moderate convergence**.

The stabilisation of inflation rates in Estonia was, first of all, made possible due to the weakening pressure of external factors, which are well characterised by changes in the growth of import and export prices. The growth of import prices, which at first reflected external developments, slowed down throughout last year (from 7.3% in the second quarter of 2000 to 0.2% in the third quarter of 2001) and was followed by the decrease of prices in the fourth quarter of 2001 as well as the first quarter of 2002. Export prices, too, began to fall after a period of growth slowdown: while in May-December 2001 the annualised price rise corresponded to a 0.8% annual increase then in the first four months of 2002 export prices dropped by 6.0% (compared to December; see Figure 3.1).

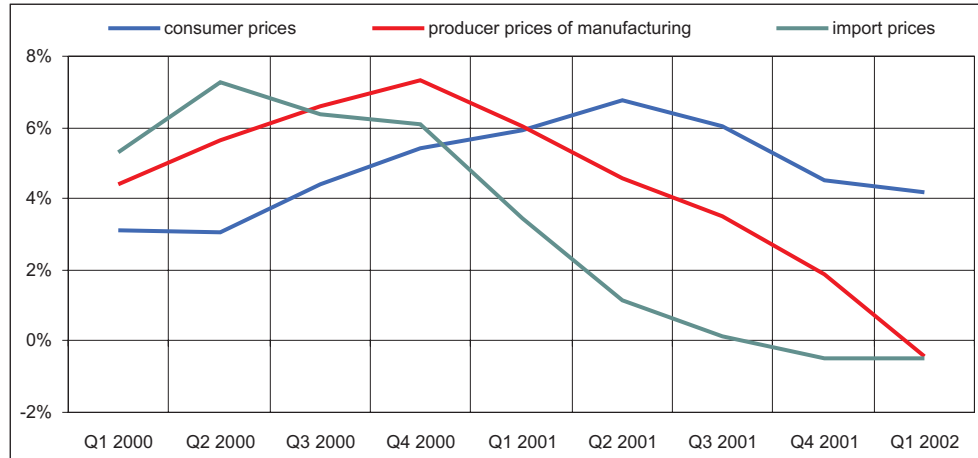


Figure 3.1. Annual growth of prices in Estonia

The slowdown of the price rise was replaced by a decrease in the **producer prices of manufacturing** as well. Producer prices react to external shocks more directly, often anticipating the dynamics of consumer prices. Still, the growth of consumer prices need not decelerate by the same degree, as it is sustained by the growth of regulated prices and the hike of food prices due to exceptional factors.

The narrowing of **inflation difference** between Estonia and the euro area to 1.8 percentage points in the first quarter of 2002, which, by certain consensus, can even be regarded to be below the equilibrium gap in the medium term, resulted from the continuing high level of inflation in the euro area rather than the slowdown of the inflation rate in Estonia (see Figure 3.2).

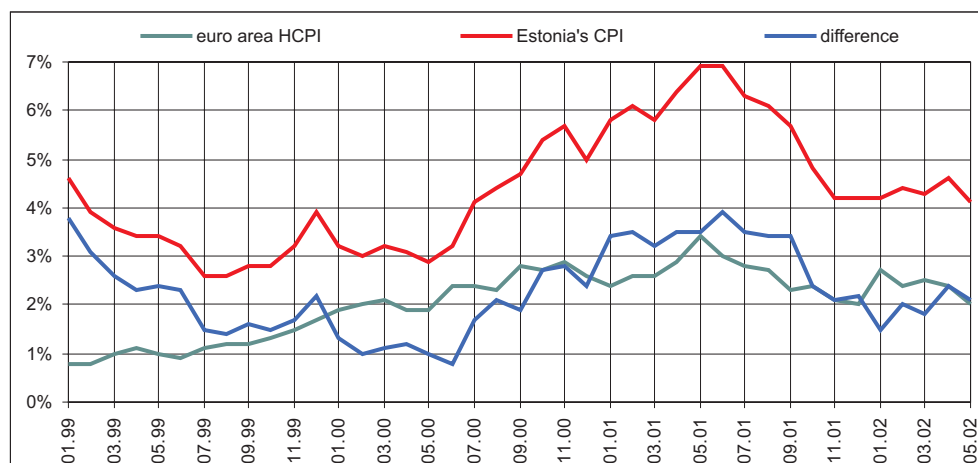


Figure 3.2. Annual growth of consumer prices in Estonia and euro area

At the beginning of 2002, the euro area inflation rate has been relatively high (constantly over 2%). It was kept high by a number of exceptional factors of temporary nature: the euro cash changeover (which, according to Eurostat, nudged the consumer prices by about 0.16 percentage points), change in the tax rates (taxes on tobacco products rose in a number of countries), increase of fruit and vegetable prices due to bad weather in the first months of the year, etc. The impact of these factors is considered to be temporary and, on the whole, **no great danger of the strengthening of inflationary pressures in the euro area** is seen at the moment, although the uncertainty of oil prices is mentioned as a possible risk factor. According to the estimates of the European Central Bank, the euro area annual inflation will stay around 2%.

Component analysis shows that most of the external inflationary pressure has resulted from the prices of food and fuel (see Figure 3.3). The slowdown of the price increase from 6% in the third quarter of 2001 to 4.4% in the fourth quarter was caused by slower increase of food prices (0.5 percentage points) and cheapening of motor fuels (0.8 percentage points). Cheapening of fuels affected inflation also in the first quarter of 2002.

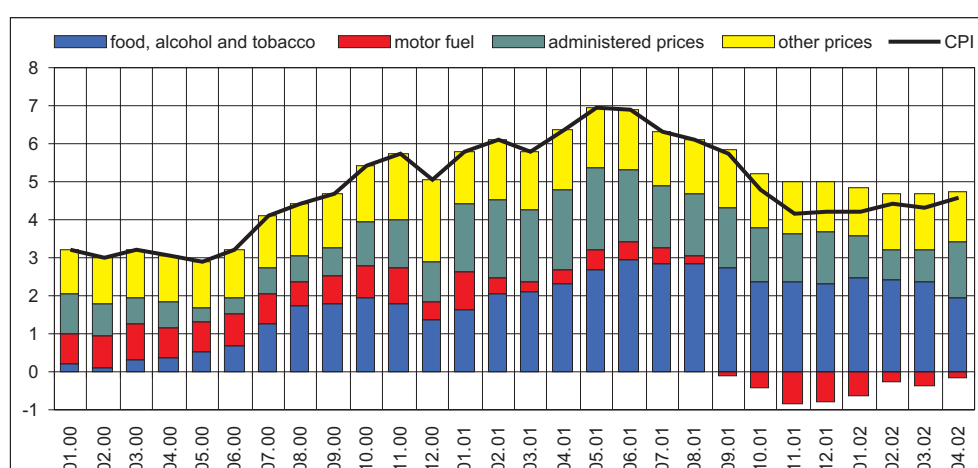


Figure 3.3. Annual change of consumer price components (percentage points)

The price increase of manufactured goods remained around 4% during both the post-Russian crisis downturn and the following upturn, slowing down to the lowest level so far (1.2–1.4%) over the past six months. In 2002, the increase of food prices has slowed down, however. Due

to the uneven rise of regulated prices the increase of services prices has varied greatly in different years – the 10–12% annual increase in 1999 and 2001 has alternated with two-three times lower increase. At the beginning of 2002 the regulation of prices was below the average (see Figure 3.4).

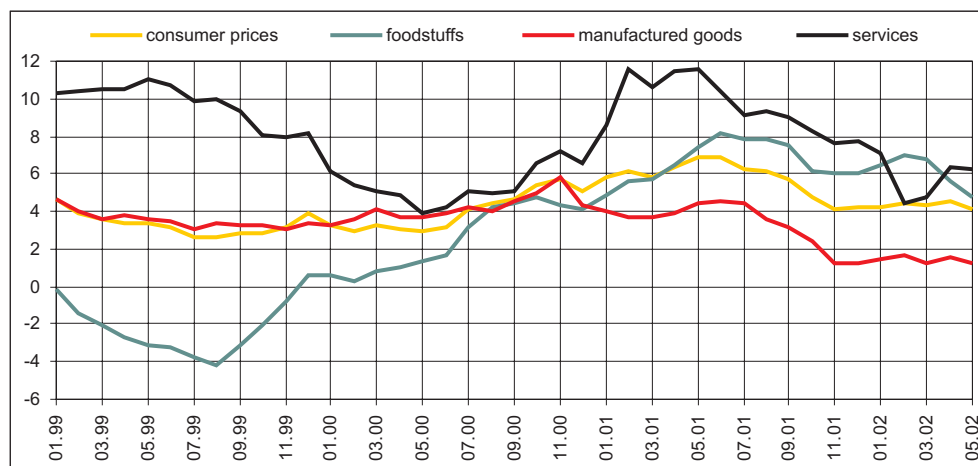


Figure 3.4. Annual growth of consumer prices by components (%)

Inflation corresponding to Estonia's current level of development was restored at the end of 2001 when the fading of external pressures combined with more modest domestic and external demand began to have a decelerating effect on the prices of both the open and the sheltered sector. The impact of the slowdown of export earnings growth and cheapening of external prices on the open sector prices and simultaneous pressure on curbing the increase of prices in the sheltered sector due to the closeness of elections led to the stabilisation of inflation in the first quarter of 2002, which will determine the development of prices throughout 2002.

Development of the Real Exchange Rate

The slight slowdown of the inflation rate corresponded to the slowdown of the increase of the real effective exchange rate of the kroon, which is based on consumer prices. The decrease of the average real effective exchange rate by 3.8% in 2000, which had already been interpreted as a short-term deviation (the change in the euro/dollar nominal rate proved to have more effect), was replaced by the average increase of 2% in 2001. The increase of the real rate slowed down to 0.4% at the beginning of 2002.

Against the currencies of transition countries, the real exchange rate of the kroon decreased by an average of 5.3% in the first four months of 2002. This was mostly due to the increase of the real exchange rate of the Russian rouble. Against the currencies of industrial countries, the real rate of the Estonian kroon increased by 2.3% on an average (see Figure 3.5).

From the point of long-term convergence of prices, a 2% increase (2–3% against the currencies of industrial countries, 0% against the currencies of transition economies) of the real exchange rate of the kroon would be more characteristic for Estonia. In this context the **0.4% average increase of the real exchange rate of the kroon in the first four months of 2002 (year-on-year) can be considered as fairly modest.**

The modest increase of the real exchange rate was, on the one hand, caused by the **harmonious effect of the inflation motors.** In this period, the higher increase of Estonian consumer prices

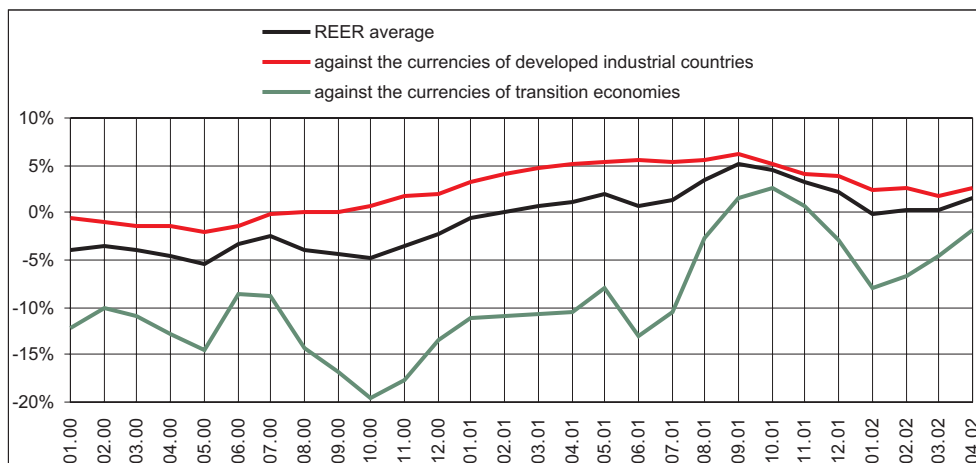


Figure 3.5. Twelve-month indices of the real effective exchange rate of the kroon

against the euro area indicators was similar to the increase of the domestic real exchange rate. In the framework of price convergence the prices of the sheltered sector should increase faster than those of the open sector, but **in proportion to the rate of the general price level convergence**.

Coming out of the economic downturn, the initial inflation accelerants were external factors that mostly led to the increase of prices in the open sector (in 2000 the increase of the domestic real exchange rate of the kroon was considerably below the general inflation gap). When domestic demand was restored, **the sheltered sector price increase** was added, which exceeded the price increase of the open sector in the first five months of 2002. This difference was 0.2 percentage points larger than the general inflation gap and also constituted **the strongest inflation factor** (see Figure 3.6).

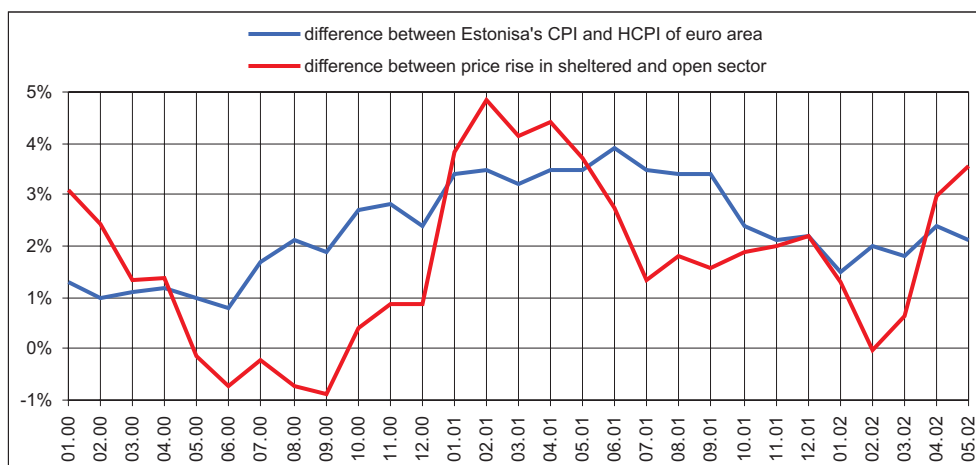


Figure 3.6. Changes in the external and domestic real exchange rate of Estonian kroon

In connection with the increase of the real exchange rate, the effect of the **nominal rate dynamics** on Estonian prices is important as well (see Figure 3.7). The exchange rate changes of the euro and the US dollar – the two most important foreign currencies for Estonia – were carried over into Estonian prices through the nominal rate channel. The weakening of the euro that lasted for two years (from October 1999 to October 2001) was replaced with the strengthening, which in recent periods has meant certain pressure towards the acceleration of the price increase in Estonia, which is a price recipient on international markets.

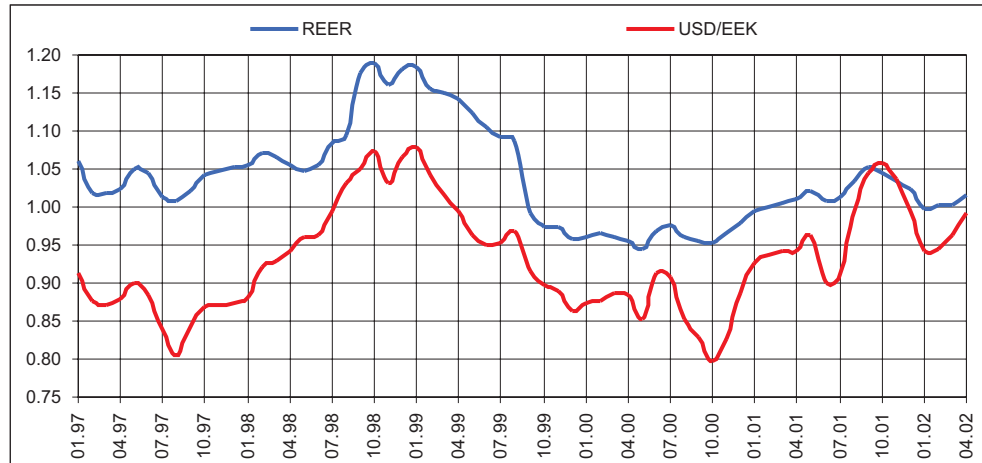


Figure 3.7. Twelve-month indices of real exchange rate of Estonian kroon and nominal exchange rate of US dollar

The 0.4% increase of the real exchange rate of the kroon (including 2.2% increase against the currencies of industrial countries) was close to medium-term equilibrium indicators and in correspondence with the below-average effect of price level convergence.