

### III INFLATION

#### CPI and Other Price Indices

In the summer of 2002, the annualised increase of consumer prices was one of the lowest since the restoration of independence. The statistical consumer basket cost 2.8% more in the third quarter of 2002 than in the respective period of 2001. This was close to Estonia's lowest price increase since the Russian crisis – in the third quarter of 1999 the CPI climbed just 2.7%. The low point of inflation was in August 2002, when consumer prices grew by 2.6% year-on-year. As could be expected, later on the annual inflation rate accelerated due to external pressures and reached 3.1–3.2% in October–November (see Figure 3.1). The annual inflation is expected to fluctuate around this level also in 2003.

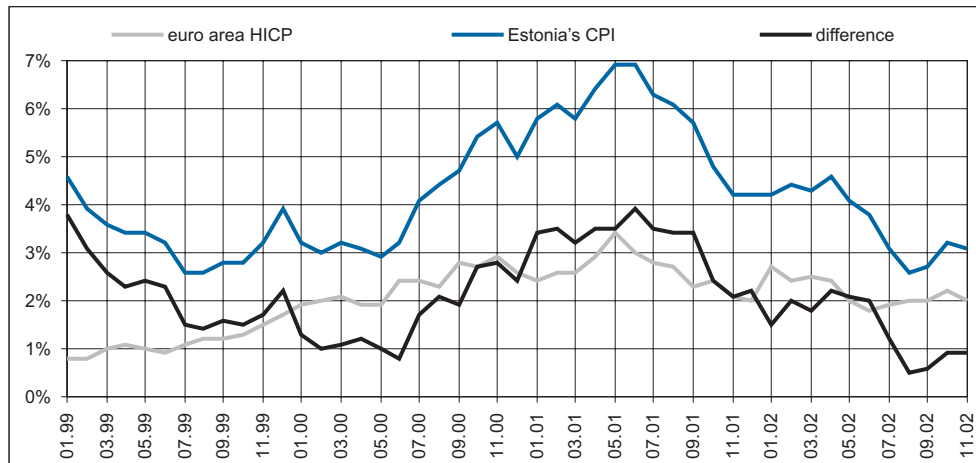


Figure 3.1. Annual growth of consumer prices in Estonia and euro area

Such price increase dynamics corresponds to the developments in the euro area, where the growth of consumer prices accelerated somewhat in the autumn months. In October, the euro area inflation climbed to 2.3%. The inflation rate was kept high by the fall of labour productivity, which was related to the slowdown of economic growth and the corresponding increase in the unit labour cost, as well as uncertainty about the changes in oil prices.

The difference between the price increases in Estonia and the euro area narrowed below one percentage point. In the longer run, such a small difference is unlikely. The core inflation, which covers nearly 70% of the consumer basket (all components except food and fuel), remained above 4% also in the summer months and the difference with the euro area was around two percentage points. This is thought to be the equilibrium difference, in view of the difference in the growth rate of productivity.

**The decrease of the inflation rate and narrowing of the difference with the euro area can mostly be attributed to changes in the most volatile components of the consumer basket – food and motor fuel** (see Figure 3.2). As already mentioned, the share of these

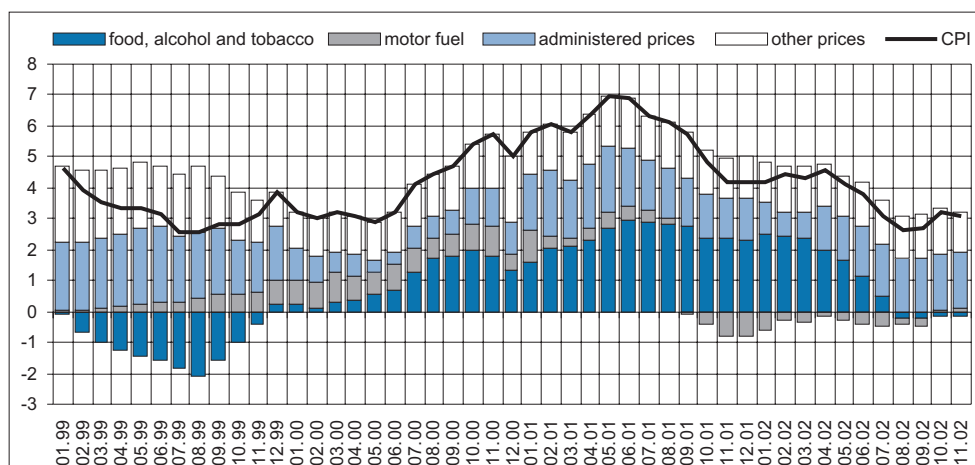


Figure 3.2. Annual change of consumer price components (percentage points)

groups of goods in the consumer basket amounts to nearly 30%, which considerably exceeds the respective figure of the euro area. Therefore, the impact of changes in food and fuel prices is greater on the Estonian CPI and hence the large fluctuations in the difference of inflation rates. In the last months of 2002, the cheapening of food products will probably stop, although in the 12month CPI index this impact should be felt until the middle of 2003.

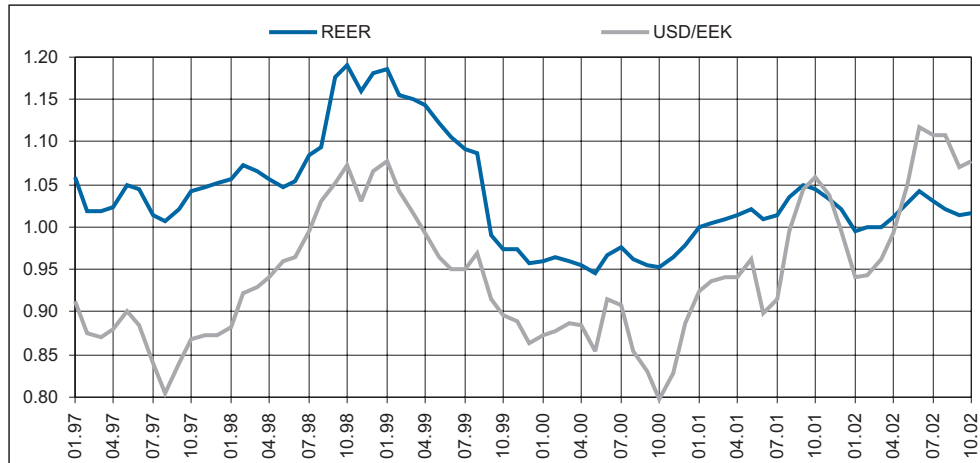
**Besides consumer prices, the reduction of external inflationary pressure resulting from the global economic slump could be noticed also in producer prices.** Thus, the producer prices of manufacturing industry dropped by 1.9% in the third quarter, while export prices fell by 6.4%, or more than in the first half of the year when the respective indicators were 0.4% and 3.1%. The same tendency continued in October-November.

The 5th of December decision of the European Central Bank to further lower interest rates indicates that the inflation rate is expected to fall in 2003, although this may not occur in the immediate future.

## Changes in the Real Rate of the Kroon

**The slowdown of the inflation rate has been accompanied by the deceleration of the increase of the real exchange rate of the kroon, which in the third quarter climbed by 1.2% against the currencies of industrial countries and by 5.6% against the currencies of transition countries.** The latter indicator can mostly be explained by the weakening of the Russian rouble. The fact that the overall increase of the real rate was just 2.6% year-on-year can be attributed to the strengthening of the Estonian kroon against the currencies of transition countries. The approximately 10% depreciation of the US dollar (see Figure 3.3) was largely neutralised by the strengthening of the Swedish krona. The greater than usual impact of changes in the nominal rate on the real exchange rate has been characteristic of the whole year. The increase of the nominal rate of the Estonian kroon accelerated year-on-year and reached 1.8% in the third quarter.

Although the annualised increase of the real exchange rate of the kroon fluctuated also against the currencies of industrialised countries in the 11 months of 2002, its dynamics can be regarded as balanced in the longer run. It reflects the domestic increase of the



**Figure 3.3. Twelve-month indices of real exchange rate of the Estonian kroon and nominal exchange rate of the US dollar**

real rate or the difference between the price increases in the sheltered and the open sector. Higher inflation rate is an inseparable part of the price convergence in the sheltered sector that is closed to competition.