III
INFLATION

Temporary Re-acceleration of Price Increase

The acceleration of the inflation rate in early 2001 was above anticipation both in Estonia and in the euro area. In May the twelve-month price increase was record high of the last two and a half years (6.9 and 3.4%, respectively). **While in the first half of 2000 Estonia's economy operated under relatively low inflation level and the price increase remained below the long-term trend, this year the circumstances are reversed** (see Figure 3.1). This is well reflected in different inflation rates: during the first four months of 2000 the average consumer price appreciated in Estonia just by 0.7 percentage points above the indicator of the euro-zone whereas this year the difference was 3.4 percentage points.

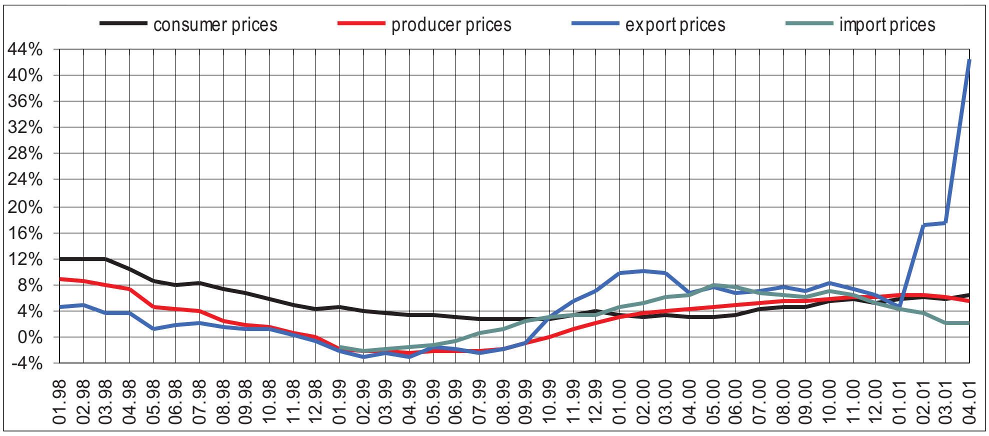

Figure 3.1. Change of twelve-month price indices

To a certain extent the re-acceleration of the price increase in Estonia was due to changes in the consumer basket as a computation base for the consumer price index (CPI) earlier in the year. Thus, the growing price indices reflect also changes in the structure of consumption expenditure. Indirect calculations show that according to the previous buying basket the consumer prices would have grown 0.5 percentage points less in the first four months of 2001 (see also Background Information, pp 30–31).

Price Increase in Sheltered Sector

Throughout 2000 the price growth in the sheltered sector remained significantly below previous periods whereas at the beginning of 2001 the inflation rate in the sheltered sector gained pace again (see Figure 3.2). Both administered and non-administered prices went up. The price growth is primarily due to increasing domestic demand that allowed to raise administered prices at the pace equal to the period two years ago, and constant infusion of continuously high fuel prices into production costs.

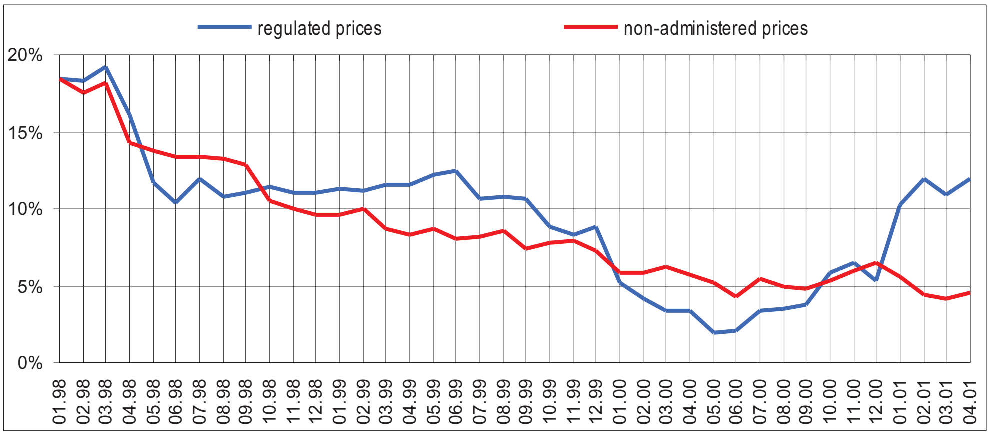

Figure 3.2. Change of twelve-month price indices of the sheltered sector

In the first quarter housing-related prices grew fastest whereas primarily subject to the 26% appreciation of electricity and 11% appreciation of heat. *Summa summarum*, housing costs sent consumer prices up by 2.0 percentage points, being responsible for 31% of the CPI growth in the first quarter. High fuel prices sustained the 20% appreciation of public transport services, having its implication on heat prices at the beginning of the year as well.

External Price Pressure

While at the beginning of the first quarter the price increase was primarily based on the sheltered sector, during the recent months the open sector has taken over with its significantly accelerating price growth (see Figure 3.3). As of end-first-quarter strengthening external pressure has, on one hand, been due to appreciating foodstuffs and, on the other hand, continuously high exchange rate of the US dollar against the euro.

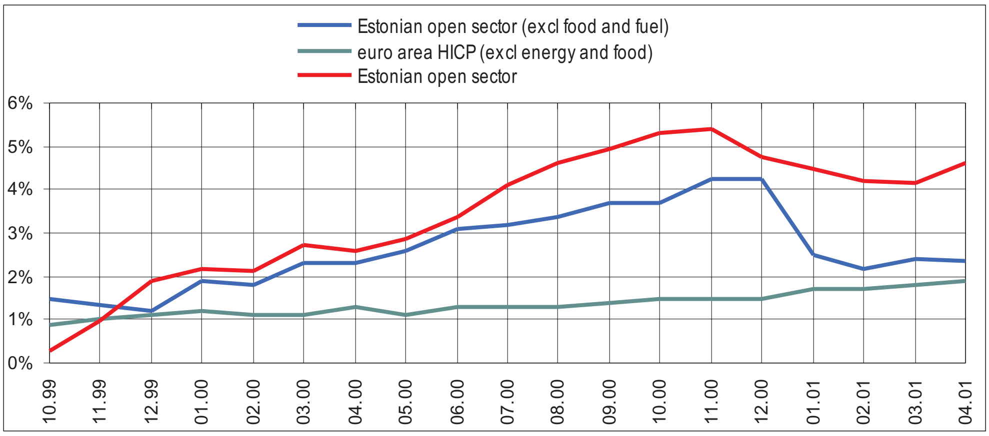

Figure 3.3. Change of Estonian open sector twelve-month price indices and euro area harmonised consumer price index (HCPI)

The appreciation of foodstuffs has once again become the crucial inflation factor. This has been largely caused by disease-induced confusion in the meat market, bringing along a foodstuff price leap from 0.2% in 2000 to 4.8% in April 2001 in the euro area (see Figure 3.4).

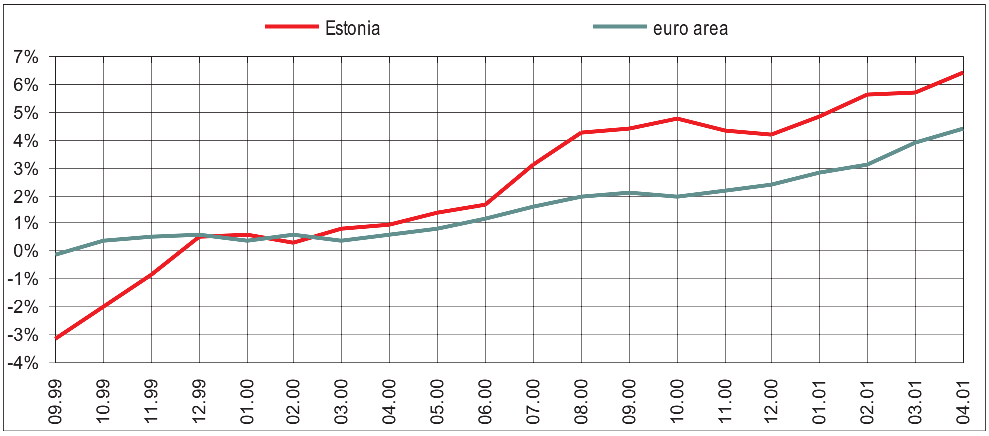

Figure 3.4. Appreciation of foodstuffs (group of goods: food, alcohol, tobacco) in Estonia and euro area (twelve-month index change)

Estonia's foodstuff prices have followed the same trend. Increasing export opportunities and emerging supply-side restrictions in meeting external and internal demand are also boosting price growth in Estonia. This led to a 7.9-percentage-point growth in foodstuff prices over the year. During the last twelve months the appreciation of foodstuffs has initiated a 2.5-percentage-point growth in consumer prices, being responsible for about 40% of the entire price increase whereas implications have been ever-increasing. No sharp halt in price growth is anticipated in near term, foodstuffs could rather appreciate above the average in near term as the result of gradual transposition of the EU agricultural policy (decrease in EU export subsidies, growth in Estonia's export quotas, etc).

External factors exercise pressure also through the above-mentioned **implication of the oil price**. Having dropped to record low of the last twenty five years in February 1999, oil prices have been increasing very fast over the last two years. The sharp price change between the first quarter of 1999 (when oil cost 10.3 euros a barrel) and the fourth quarter of 2000 (34.5 euros a barrel) can be considered the fourth price shock of the last thirty years. The price of crude oil in euros has about tripled. Unfortunately implications of the shock to the global economy, inflation and monetary policy can be evaluated only indirectly[1].

The growing crude oil price sent Estonia's motor fuel prices in April 2001 two thirds above the beginning-of-1999 level. Although the further price increase will not be as excessive and earlier this year a slight downward revision took place, **the continuously high price level of oil could sustain a growth of some prices both in Estonia's open and sheltered sectors**.

The ongoing external pressure indicates that the upcoming slowdown of the inflation rate will remain below anticipation. Both in the euro area and in Estonia the inflation rate has accelerated mainly because of growing food prices induced by beef-related concerns and the after-effects of the tripled price of crude oil, accompanied by a price growth based on increasing domestic demand in the sheltered sector at the beginning of the year.

[1] Macro-economically turbulent times and oil price implications on the economic activity and post-oil-shock inflation have been studied repeatedly. A pronounced negative link between the oil price and main indicators of economic activity as well as significant correlation between the oil price and inflation rate has been identified. Thereby links between oil price changes and economic activity indicators are clearly asymmetric: oil price shocks of 1970ies inhibited economic activity significantly whereas the impact of price drop on production growth was more modest. Thus, the increase of the oil price has a larger impact on economic activity than the price fall. The monetary policy oriented to bringing down the rapid inflation rate caused by the oil shock has actually been one of the reasons why oil shocks have been followed by growth slowdown (see also The Macroeconomic Effects of Higher Oil Prices. IMF Working Papers. WP/01/14, January 1, 2001; http://www.imf.org).

REER and Competitiveness

Despite of the accelerating inflation rate the real effective exchange rate of the kroon (REER) calculated on the basis of consumer prices did not change in the first quarter of the year. The real effective exchange rate of the kroon rose against currencies of industrial countries by 4%, being, however, offset by a 10.9%-drop against currencies of transition economies (see Figure 3.5). The exchange rate of the kroon against the Russian rouble fell by 18.8%. In early 2001 prices in Russia underwent a preferential growth compared to prices in Estonia. Thus, the difference in price levels after the 1998 rouble crisis has shrank to minimum.

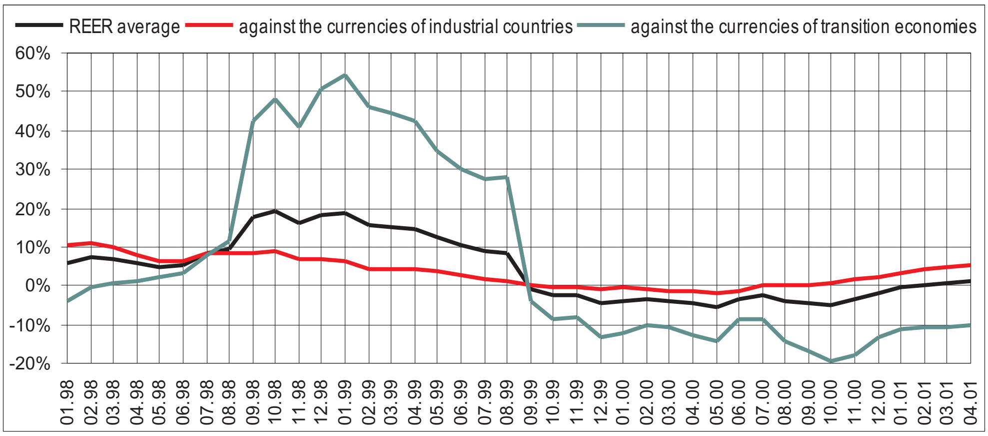

Figure 3.5. Change of the real effective exchange rate (REER) of the kroon

The price level in Latvia and Lithuania expressed in Estonian kroons is continuously above Estonia's level. Here Estonia gets slight competitive advantage. In the first quarter the real exchange rate of the kroon against the Latvian lats was 2.6% higher against the year-ago period, remaining against the Lithuanian litas 0.2% below. This fact did not really affect the above-mentioned competitive advantage.