III
INFLATION

Consumer Price Index

Low annual consumer price growth in Estonia, which was indicative of 2003 and the beginning of 2004 when the CPI basket price occasionally increased by less than 1% on the annual basis, has been left behind for the time being. The underlying reasons for such a slow rise were above all cheaper food and fuel as well as comparatively few administered price actions early in 2003. Due to the more substantial weight of food in the CPI basket, Estonia's inflation rate fell behind of the respective euro area indicator for the first time ever (see Figure 3.1).

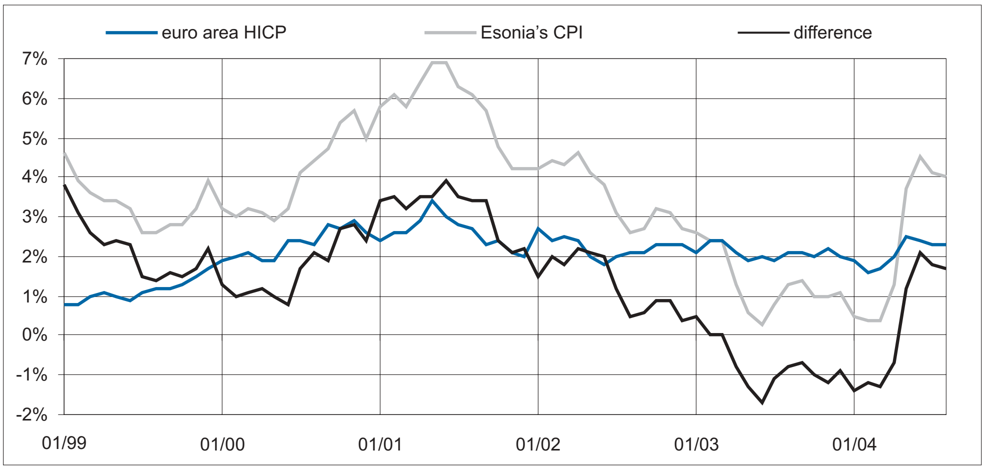

Figure 3.1. Annual growth in consumer prices in Estonia and the euro area

In the second quarter of 2004, the annual consumer price growth accelerated and amounted to 3.2%. This was mainly caused by the one-off price rise arising from the accession to the European Union, which was spurred by the implementation of common customs tariffs and the elimination of the European Union export subsidies, as well as by the harmonisation of fuel excise duties. In addition, surging crude oil prices on the world market in May and June contributed to inflation as well. The annual consumer price of the euro area reached the 2% level as well towards the end of the second quarter but the rise was not as fast as in Estonia. Thus, Estonia's inflation rate outpaced the respective euro area figure as of May – by an average of 0.9 percentage points in the second quarter (2.1 percentage points in June).

Even though the growth rate of annual consumer price remained above 4% also in the second half of the year, this is no indication of stronger inflationary pressure. Leaving aside the partial one-off rise in food and fuel prices in May and June, the prices of other CPI basket components stabilised in the second quarter: the core inflation rate remained under 2% also in June and declined to 1.5% in July. Besides, the sustained annual CPI rise also reflects the base effect caused by cheaper food prices in 2003 (see Figures 3.2 and 3.3). However, the relatively extensive one-off price explosion in May and June means that the average CPI growth this year might turn out to be bigger than the 2.8% expected in the spring.

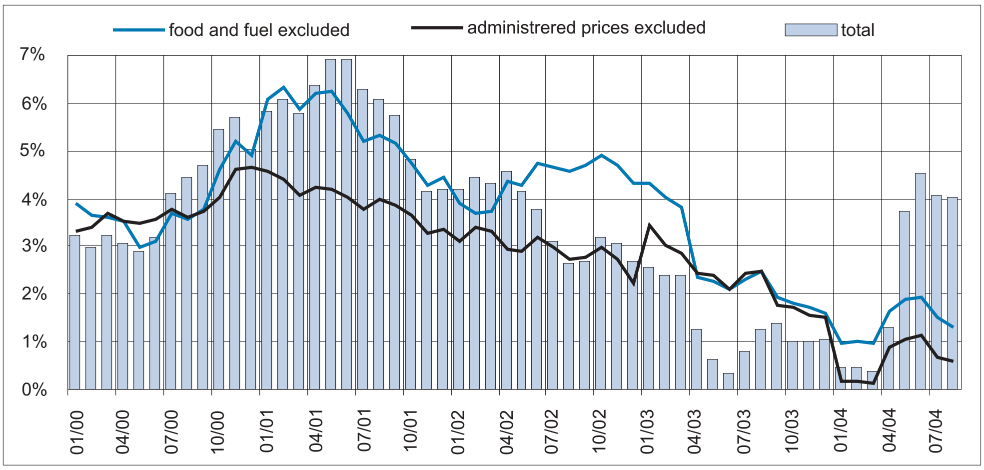

Figure 3.2. Annual growth of consumer prices

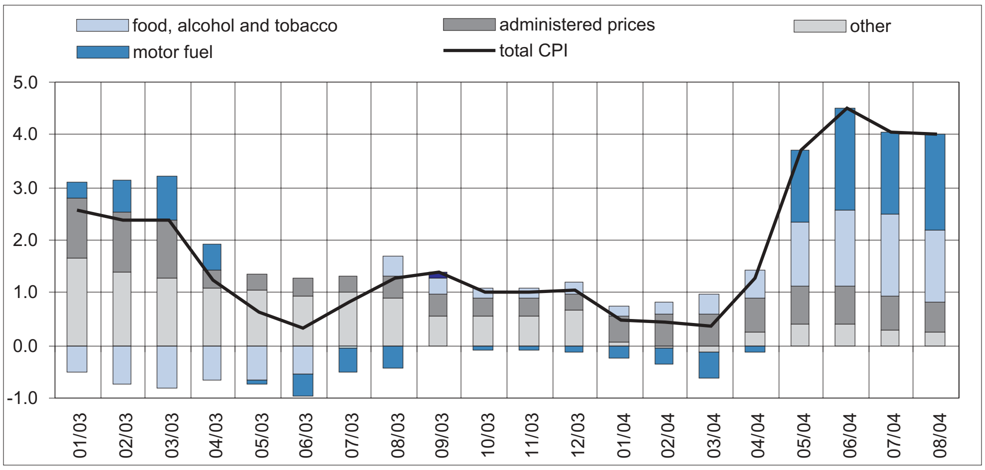

Figure 3.3. Annual percentage point contribution to CPI inflation

Similarly to consumer prices the producer prices in manufacturing rose faster in the second quarter as well because of more expensive raw materials. These prices fell by 0.2% last year, however in the first quarter of 2004 the decline in prices was replaced by a 0.6% rise. In the second quarter the prices went up by 2.7% and in June the rise was 3.8%. The producer price index of manufacturing was most affected by price growth in the food and wood processing industries and metal product manufacturing.

Labour Costs

Most indicators suggested a growth in labour costs in 2003 and the first signs of a slowdown were evident at the end of the year and at the beginning of 2004. The nominal wage growth was approximately 3 percentage points slower in the first half of 2004 compared to the year before and the rate was reduced to 6.5% in the first quarter. In April and May wage growth picked up again and increased by 7.5% while remaining within the same range with the growth in labour productivity, according to preliminary estimates.

Wage growth remained consistently slow in smaller companies with up to 50 employees and was limited to 2% throughout the first half-year. In large companies wage growth was faster, even though on average the pace slowed down in all private companies from 11.8% in the fourth quarter last year (11.5% in 2003) to 5.2% in the first quarter of 2004 and was sustained on that level in the second quarter. Wage growth in foreign owned companies gathered pace from 6.6% early in the year to 8.5% in April-June. In companies/institutions owned by the state and local governments wage growth has not showed any signs of a slowdown this year and has consistently remained at approximately 10%.

In line with slower nominal wage growth real wages did not grow that fast either – the respective indicator fell from an average of over 8% in 2003 to 6% in the first quarter of 2004. Due to increasing inflation rate the growth in real wages eased off even further in the second quarter, and the respective rate stood at 4%. Since the extent of inflation in April-June was somewhat unexpected, such a decline in real wage growth might have been of "technical nature" and need not reflect a sustained slowdown.

The consistent and relatively fast growth in exports shows that increasing labour costs have not reduced the competitiveness of Estonian companies. Faster productivity growth, compared to wage costs, is a prerequisite for maintaining sustained economic growth. The trends of the past year and a half indicate that even though the share of wage costs in the gross domestic product has remained comparatively stable (see Figure 3.4), such costs have briefly outpaced productivity in some periods.

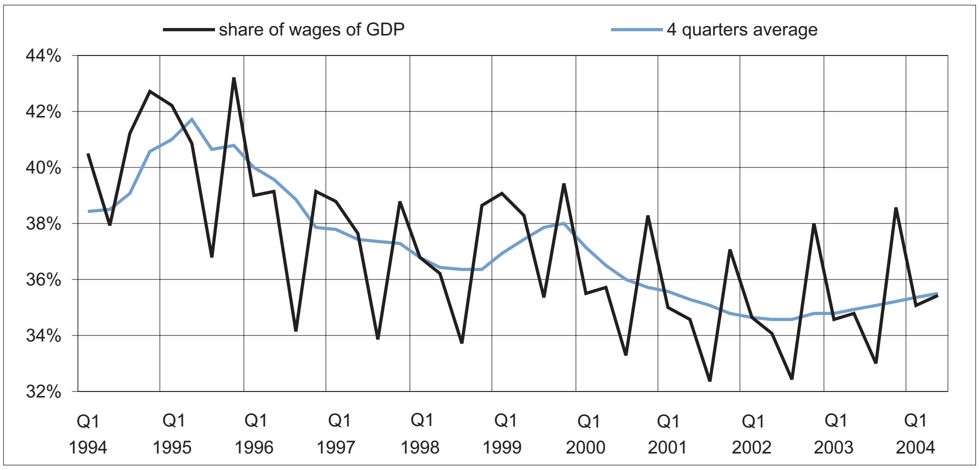

Figure 3.4. Change in the share of wage costs in GDP

Real Exchange Rate of the Kroon

The fast rise in consumer prices was also reflected in a faster rise in the real exchange rate of the kroon. **The real effective exchange rate of the Estonian kroon went up by 0.8% in the second quarter, which was 0.9 percentage points higher compared to the previous quarter.** This time the rise in the real exchange rate was spurred by the relatively fast inflation rate in Estonia, whereas the impact of the nominal effective exchange rate remained modest.

Arising from accelerating inflation in Estonia, the real exchange rate of the Estonian kroon against the currencies of industrial countries rose by 2.7% in the second quarter after the 0.5% rise in the first quarter. The average real exchange rate of the kroon against the currencies of transition economies depreciated faster as well, i.e. by 3.9% compared to 1.5% in the first quarter. The Estonian kroon depreciated by 1.2% against the Latvian lat, appreciated by 1.7% against the Lithuanian litas, and depreciated by 7.1% against the Russian rouble. This was due to the fact that Latvian and Russian inflation rates outpaced the respective rate in Estonia (exceeding the combined effect of the change in the nominal exchange rate and Estonia's inflation rate).

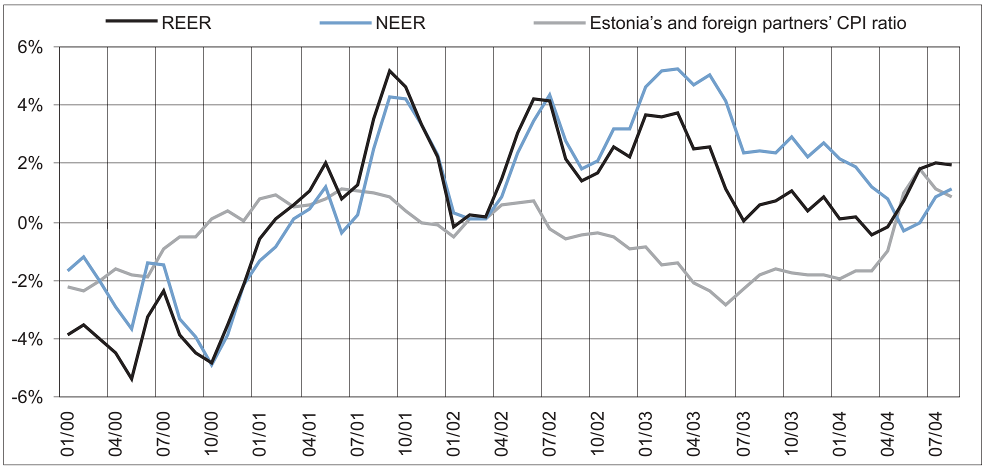

Figure 3.5. Annual change of real (REER) and nominal (NEER) effective exchange rate of the Estonian kroon

Independently from domestic price changes, the terms of trade turned out to be less favourable for Estonia in the second quarter and the rise in import prices outpaced that of export prices by 1.6 percentage points. While export prices rose by 6.6% last year and import prices fell by 1.7%, then the difference in the growth rates levelled out in the first quarter (the growth in export prices eased down to 3.6% and the decline in import prices to 1.3%). The slowdown in export prices continued in the second quarter (to 1.0%), meanwhile import prices rose by 2.6%. A significant factor affecting import prices towards growth was the rise in fuel prices on the world market. In July export prices increased by 1.4% and import prices by 2.0% on average.