

BACKGROUND INFORMATION

HOW PRECISELY CAN THE INFLATION RATE BE PREDICTED IN THE FOLLOWING YEARS?

During the current period of stable prices, i.e. the period of slow price growth – the development stage that Estonia has now entered – it is obvious that the prices of some goods and services increase abruptly. These are regulated prices so as to ensure competition. In order to change such prices it is necessary to go through a comparatively long procedure and therefore the rise in administered prices is also abrupt.

If the overall price increase is slow, such one-off price growth results in a fast rise in the price of the total consumer basket. In a broader sense, the prices of such goods in case of which indirect taxes constitute a significant price component (e.g. alcoholic beverages, tobacco products, motor fuel), making price dynamics less smooth as well (see Figure a), can also be classified as administered prices.

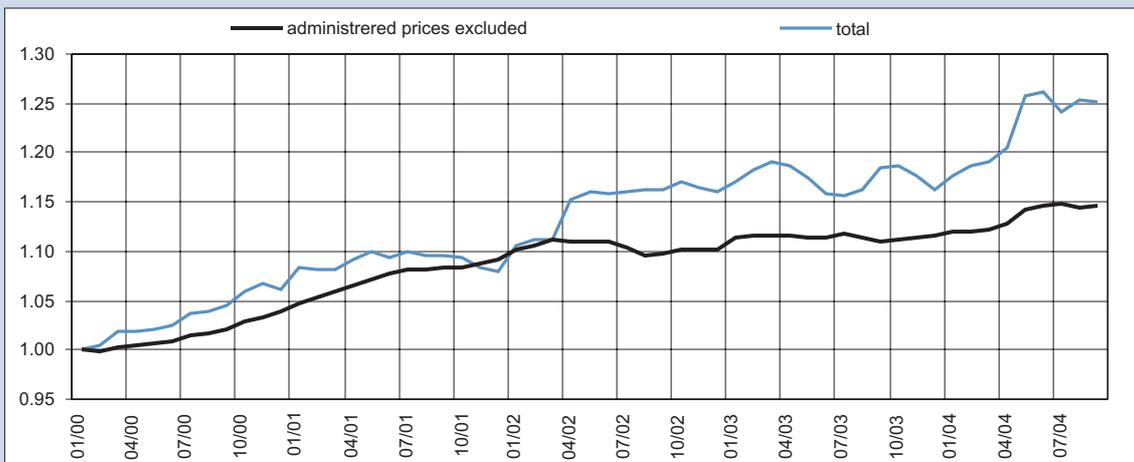


Figure a. Changes in the consumer price index with and without administered prices

Among the regulated prices (in order to ensure competition), the change in electricity prices has the most significant impact on the overall price level due to their relatively high share in the basket of goods and services. Because of the need to cover the costs of environmental investments of the power plants, the raising of the electricity prices is on the agenda. Based on the assumption that electricity prices will be raised by 15%, for instance, the direct influence of such an action alone on the consumer price index is 0.5 percentage points. Since the price of electricity

affects production prices of many consumer goods, the rise in electricity price also produces the so-called second round effect, which is why the impact of electricity price rise on consumer prices might reach 1 percentage point. Naturally, the extent of the transition of the rise in production input prices into the final products depends on the price-sensitivity of the consumers, toughness of competition, etc.

Eesti Energia has been requesting a price rise from the Energy Market Inspectorate since spring 2004.

Respective proceedings have been terminated several times and the rise is not considered to be likely before the second quarter of 2005. In the longer run, it does not matter how evenly and when exactly administered prices change, but it will be a somewhat special situation in the coming years.

Namely, such ambiguity makes it complicated to predict the growth in consumer prices not only in the sense of accuracy, but it also makes it difficult to find an answer to the question as to when Estonia could meet the Maastricht criterion for inflation. Estonia has set itself the aim of adopting the euro as soon as possible and in order to serve that purpose the country joined the exchange rate mechanism (ERM II) on 28

June 2004. This is a period that lasts at least two years during which, among other things, the ability of the Estonian economy to level asymmetric price shocks is tested. The performance of the markets is regarded sufficiently flexible and the markets are considered to be ready for the changeover to the euro if, during the evaluation period, the inflation in Estonia does not exceed the rise in consumer prices in the three best-performing European Union member states regarding price stability by more than 1.5 percentage points (one of the so-called Maastricht criteria). The length of the evaluation period is 12 months and, in principle, we can choose the time ourselves. The constant postponement of the rise in the electricity price makes it difficult to choose a period suitable for evaluation.