

III INFLATION

Consumer price index

The consumer price growth slowed down slightly from 4.3% in the third quarter to 4.0% in the fourth. The inflation was again mainly affected by the fluctuation of oil prices.

In the first quarter of 2006, the consumer price growth increased again. According to the Statistical Office, consumer prices rose 4.4%, year-on-year (see Figure 3.1). In addition to the rapid price increase of motor fuel, this time the consumer basket was substantially influenced also by the prices of housing-related goods and services. Compared to January 2005, for instance, this January the prices of water supply, sewerage services and heating grew 8.7%.

The Estonian core inflation indicator continued its ascent as well. While in autumn it was mainly brought about by the higher prices of clothing, footwear and headgear and the impact of rising motor fuel prices on other prices (mainly transport services), at the beginning of 2006 the increased spending on leisure activities was the main driving force behind inflation. Although the prices of communication services decreased, they failed to balance the price pressures (see Figure 3.2 and 3.3).

According to the forecast of Eesti Pank, the price increase is not expected to slow down considerably before the summer. Potential changes in fuel prices continue to be the major risk factor that might increase the level of inflation.

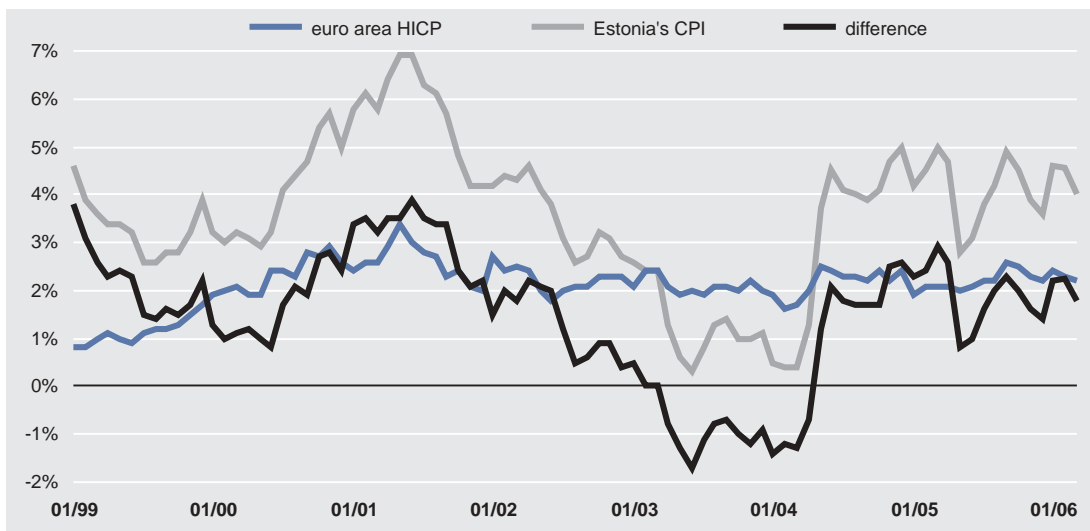


Figure 3.1. Annual growth in consumer prices in Estonia and in the euro area

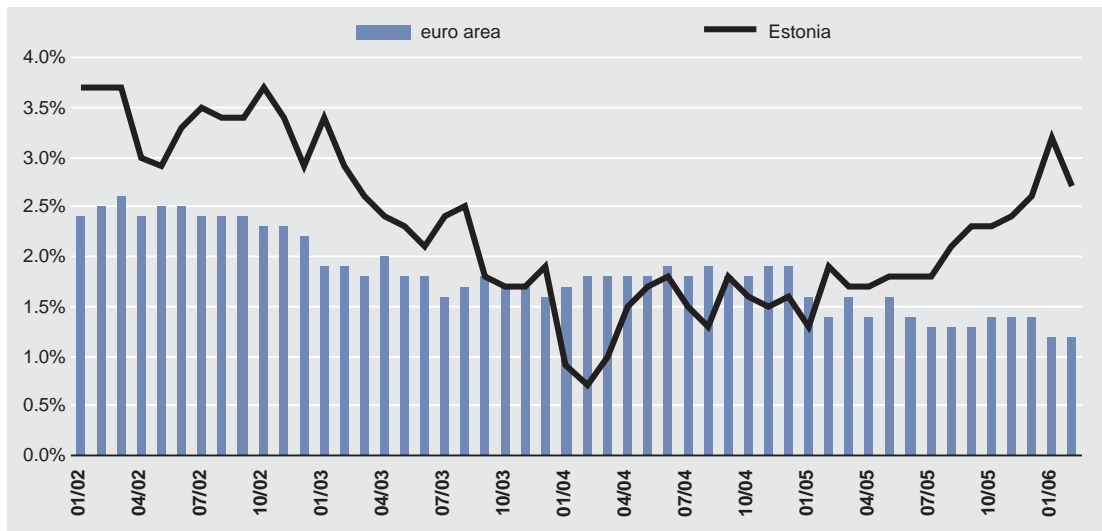


Figure 3.2. Core consumer price inflation (all components, except food, alcohol, tobacco and energy)

Source: Eurostat

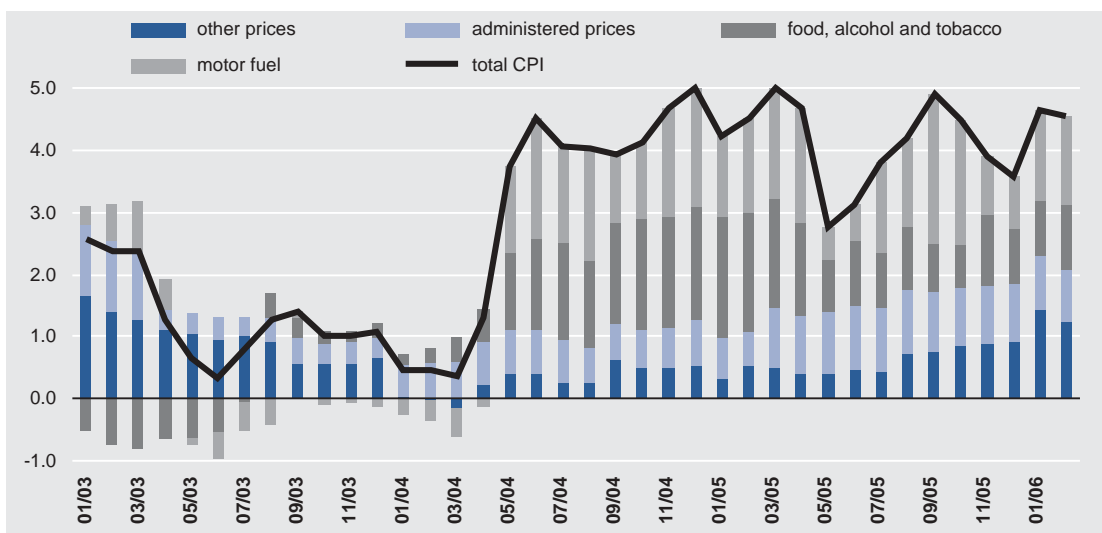


Figure 3.3. Contributions of various goods and services to CPI growth (percentage points)

Labour costs

In the fourth quarter of 2005, the average gross monthly wages amounted to 8,690 kroons. This means that nominal annual growth accelerated to 12.8% again (10.9% in the third quarter and 11.8% in the second quarter). The average gross hourly wages grew from 9.5% in the third quarter to 15.9%. According to the Statistical Office, the wage rise was influenced by one-off premiums paid in the fourth quarter. Such premiums increased 25.5%, year-on-year. As a result of the income tax reduction, net monthly wages increased faster than gross monthly wages, reaching 13.5% in the third quarter and 14.5% in the fourth quarter.

By fields of activities, in the fourth quarter of 2005 average gross monthly wages increased the most in the sphere of hotels and restaurants (24.3%) and decreased only in fishery (7.4%), compared to the fourth quarter of 2004. Rapid wage growth continued in the primary sector probably thanks to the Structural Funds (17.3% in forestry and 19.8% in agriculture). In manufacturing wages also increased somewhat faster – by 14.4%. As wages in industries with lower

wage levels generally grew faster than average, the distribution of wages in terms of the amount became slightly more homogeneous.

The wage increase was again faster outside Tallinn, yet wages rose also in Tallinn from 6.9% in the third quarter to 9.2%. For the first time, the average wages exceeded 10,000 kroons. Over the year, the average wages grew the fastest in Jõgevamaa (24.6%), probably owing to the wage rise in agriculture.

Considering the slowdown of inflation to 4.0% in the last quarter of 2005, the real growth of average gross wages increased up to 8.5% in the fourth quarter (6.5% in the third quarter) and the real growth of net wages rose to 10.1% (8.8%).

All in all, in 2005 the real growth of labour productivity remained in line with the real wage growth. Compared to the previous year, the share of the wage fund in GDP (i.e. real unit labour costs) decreased by 0.1 percentage points to 35.0% of GDP, despite faster employment and wage growth (see Figure 3.4).

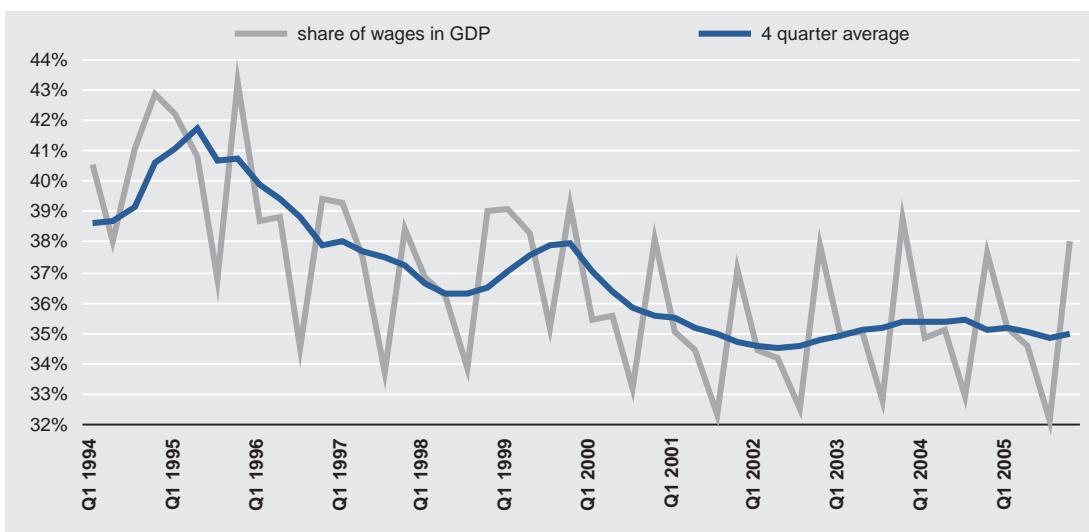


Figure 3.4. Share of wage costs in GDP structure

Real exchange rate of the kroon

Although inflation picked up in Estonia in 2005, the growth of the real effective exchange rate¹ of the kroon was not as substantial.

The real exchange rate of the Estonian kroon appreciated by 1.1% against the currencies of major foreign trade partners, year-on-year (see Figure 3.5). Estonian inflation in 2005 exceeded the average inflation of trade partners by 0.7%. The real exchange rate appreciated by 0.4 percentage points, owing to changes in

the nominal exchange rate (mainly the euro and the US dollar).

While there is price competition between Estonia and transition economies (due to a similar price level), the prices of industrial countries still remain much higher than Estonian prices. The appreciation of the real exchange rate against the latter may be regarded as an indication of price convergence.

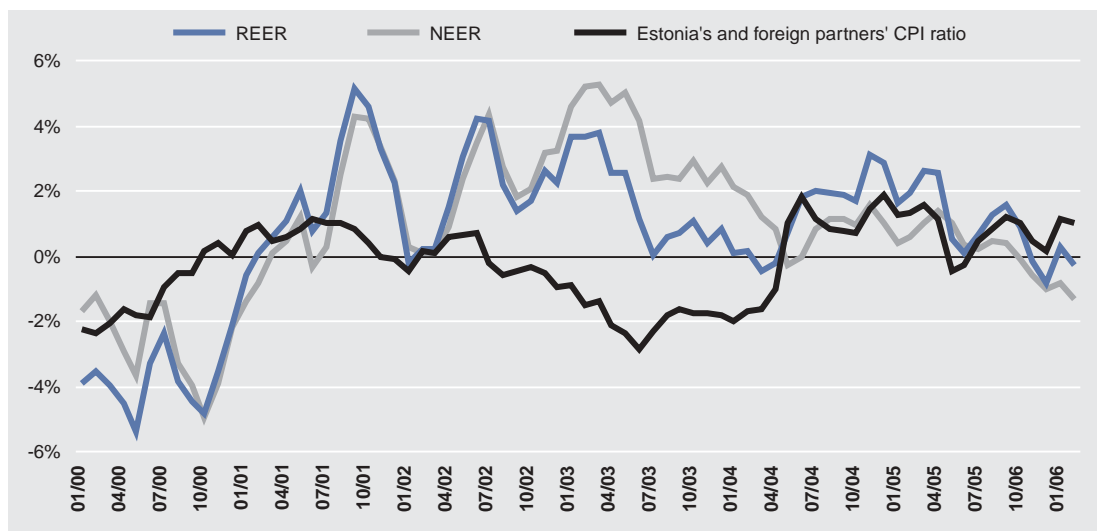


Figure 3.5. Change in the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

¹ The index of the real effective exchange rate (REER) of the kroon describes exchange rate changes of the kroon against the currencies of nine major trading partners of Estonia and changes in Estonian consumer prices against the prices of these trading partners. It is based on the structure of Estonia's foreign trade turnover.