

III INFLATION

Consumer price index

Contrary to expectations, the decrease in consumer price inflation that occurred in the final months of the previous year ended in 2006.

Already in the first months of this year, inflation exceeded 4% again and remained in the range of 4.5% until the end of the summer. According to the Statistical Office, in the second and third quarter consumer prices rose just as much as in the first quarter, i.e. by 4.4% (see Figure 3.1). Therefore, a nearly 2 percentage point difference with the respective euro area indicator persisted.

By months, the inflation rate proved to be rather different, remaining in the range of 3.8–5.0% from January to October. The underlying reason for such instability was the oil price volatility in the global market. Although the share of motor fuel in the consumer price index (CPI) did not decline year-on-year and high fuel prices prevented the inflation from dropping until September, inflation started to be increasingly affected by core inflation pressures. The persistence of inflation gradually began to reflect the rapid economic and wage growth more explicitly.

The Estonian core inflation accelerated from less than 3.0% at the beginning of the year to 3.2% in the second quarter and stood at 3.7% in July and August. Inflation picked up mainly owing to the larger than usual increase in housing costs: both the prices of construction materials as well as rental and repair services rose faster (see Figure 3.2).

In addition to the aforementioned goods, inflation was also substantially influenced by the increase in expenses related to leisure activities and the accelerating price growth of clothing and footwear. Moreover, the growth of food prices accelerated (up to 3.5% in the second quarter and 6.1% in the third quarter), generally adhering to prevalent trends in the euro area, but exceeding the price rise in the euro area by 2 percentage points (see Figure 3.3). As this summer's weather was unfavourable for agriculture and horticulture, the seasonal price decline of food at the end of the summer also remained minimal.

Fast price dynamics were also supported by import price pressures that affect several goods groups. In July, the inflation of import and producer prices reached nearly 5%, also exerting pressure on the consumer price inflation.

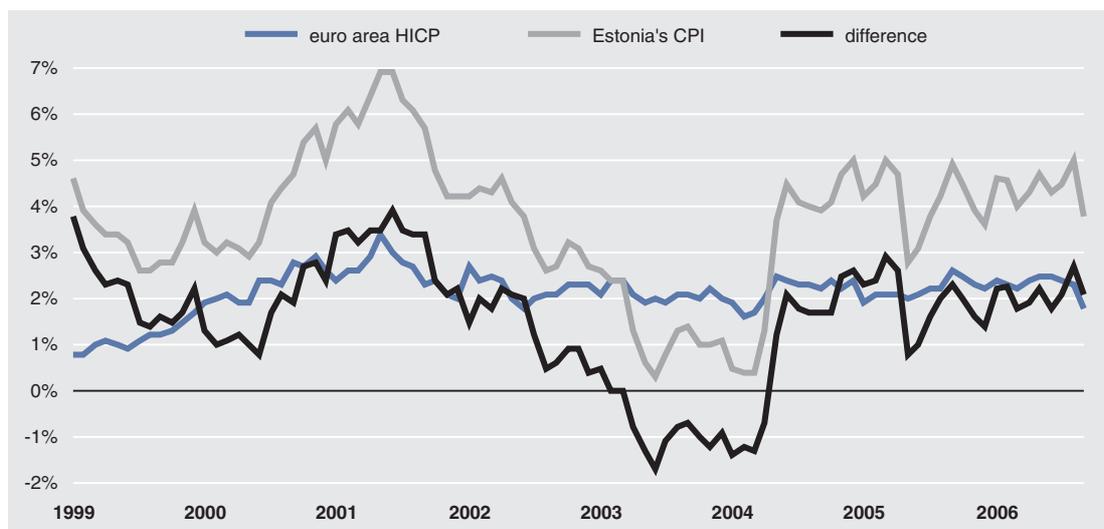


Figure 3.1. Annual growth in consumer prices in Estonia and in the euro area

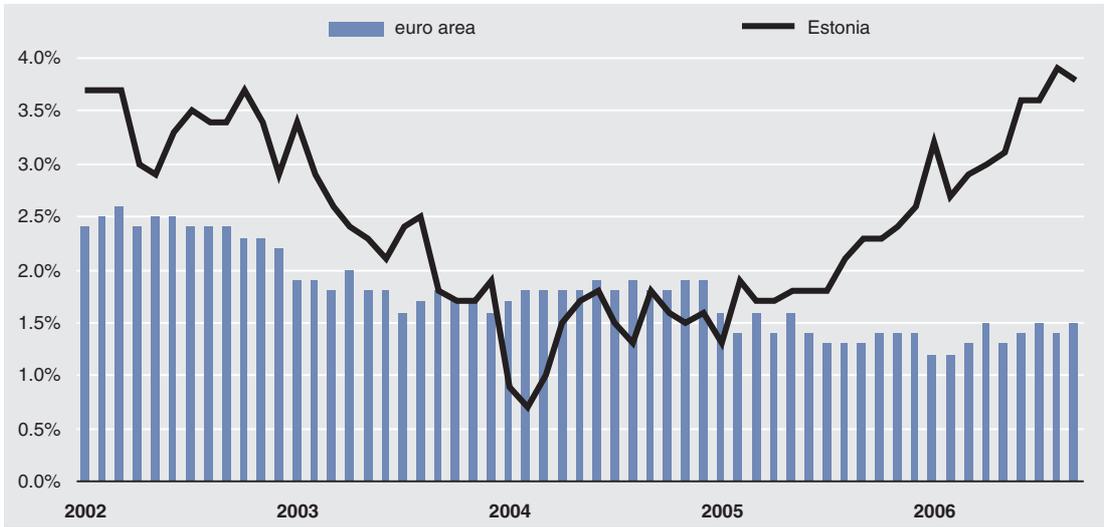


Figure 3.2. Core consumer price inflation (all components, except food, alcohol, tobacco and energy)

Source: Eurostat

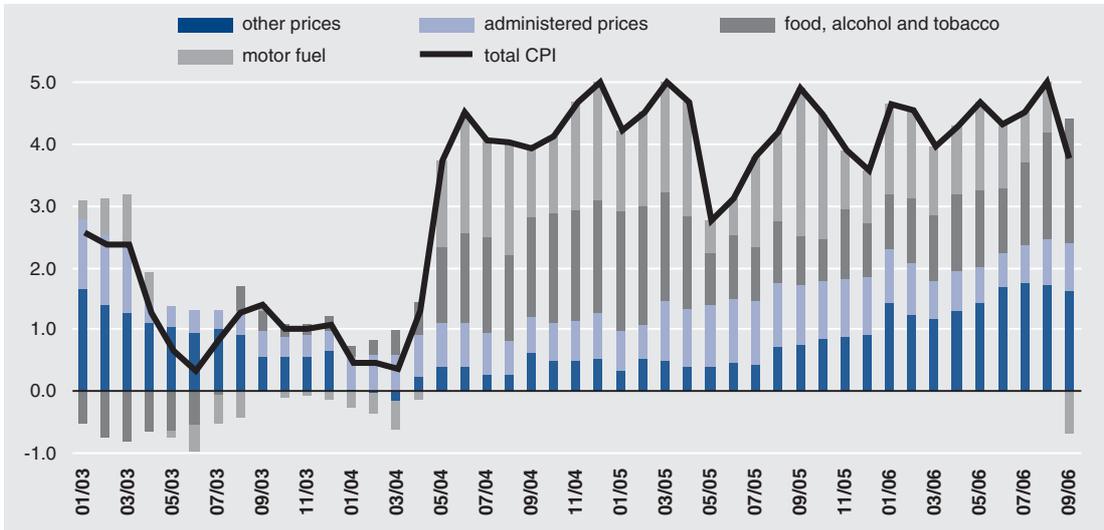


Figure 3.3. Contributions of various goods and services to CPI growth (percentage points)

Labour costs

In 2006, labour costs also increased faster than expected. Average gross monthly wages rose by 15.7% in the first and by 15.0% in the second quarter of 2006. Meanwhile, the growth of gross hourly wages excluding holiday pays and benefits amounted to 17%. Wages rose by 43.4% in fishery, which has a small share in the overall employment; however, the significance of increasing wages was far greater in the fields of wholesale and retail trade (21.7%), hotels and restaurants (15.8%) and manufacturing (15.6%), namely in areas with a greater number of employees. Wages continued growing rapidly also in agriculture – by 22.5%.

By economic sectors and ownership, this time wage growth remained relatively homogeneous. In companies belonging to Estonian private persons, the average gross monthly wage growth was only 2.7 percentage points faster than in companies owned by foreign private persons. Wage growth in the public sector remained in the range of 12–13%. The ongoing reduction of the personal income tax rate did not cause a slowdown in wage growth owing to the increasing demand for labour force.

Tax changes brought along a nearly 1 percentage point decrease in the real effective personal income tax rate. Therefore, the growth rate of average net wages accelerated to an estimated 17%.

Given the inflation rate of 4.4%, the real growth of average gross wages picked up to 10–11% in the first half-year. This can be regarded as the highest indicator of the past years, as in 1997, for instance, real wage growth remained below 10%, although GDP growth exceeded 11%.

In the economy as a whole, the real growth of labour productivity remained in line with real wage growth. The share of the wage fund in GDP (i.e. real unit labour costs) decreased further in the first half of 2006. This occurred despite faster employment and wage increase (see Figure 3.4). Nevertheless, in some fields of activity, for instance in manufacturing, wage growth even picked up alarmingly.

Real exchange rate of the kroon

In the first half of 2006, the Estonian inflation rate was higher than the euro area average. Although Estonia's inflation was 0.9 percentage points higher



Figure 3.4. Share of wage costs in GDP structure

compared to the weighted average inflation rate of our trade partners, the real exchange rate of the Estonian kroon appreciated against the currencies of major foreign trade partners merely by 0.2%, year-on-year (see Figure 3.5).

Though the Estonian kroon has appreciated against the US dollar since the beginning of 2006, the kroon exchange rate did not reach the year-ago level. Year-on-year, the nominal exchange rate of the Estonian kroon depreciated altogether by 0.7%, mainly owing to changes in the exchange rates of the euro and the US dollar. The deprecia-

tion of the kroon's nominal exchange rate may in turn have fostered the relatively fast and persistent price rise.

In 2006, the real exchange rate of the Estonian kroon appreciated against the currencies of advanced economies as much as last year and ranged within 3.0–3.5% in most months. This indicates the ongoing price convergence, as according to estimates, the average price level of Estonia does not even exceed 60% of the average price level of old EU Member States (with the exception of a few goods groups).¹

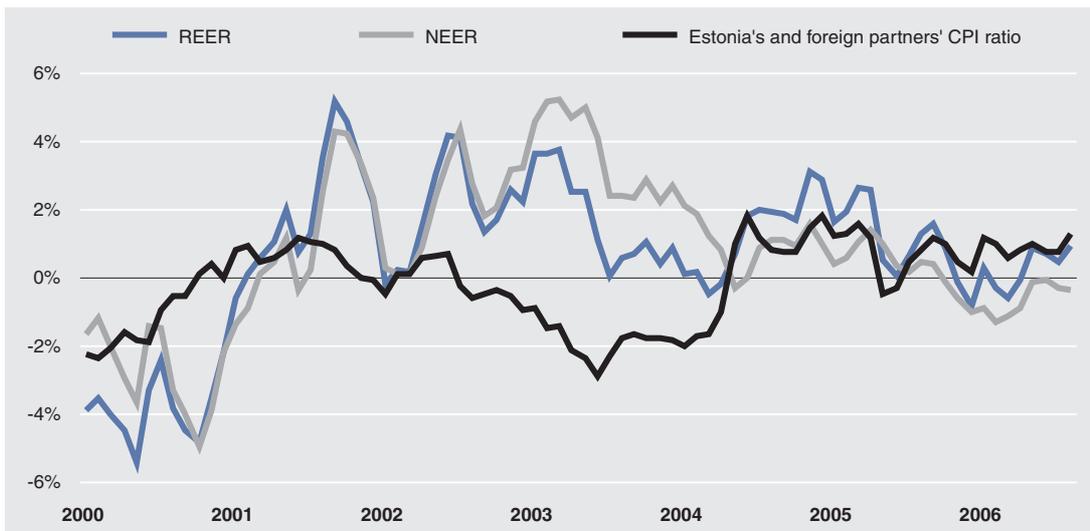


Figure 3.5. Change in the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

¹ See also background information "Prices in the Estonian construction sector closest to the EU-15 average" on page 28.