

III INFLATION

The anticipated recovery of price growth took place in the second quarter of 2000, much later and to a lesser extent than forecast. The main inhibiting factors of the price growth are ongoing accelerated disinflation in the sheltered sector and the lower-than-anticipated growth in food prices (in June an annual of 1.4%). Most of the open sector prices behave as anticipated and like at their key trade partners' whereas the growth in the sheltered sector was the most modest (see Figure 3.1).

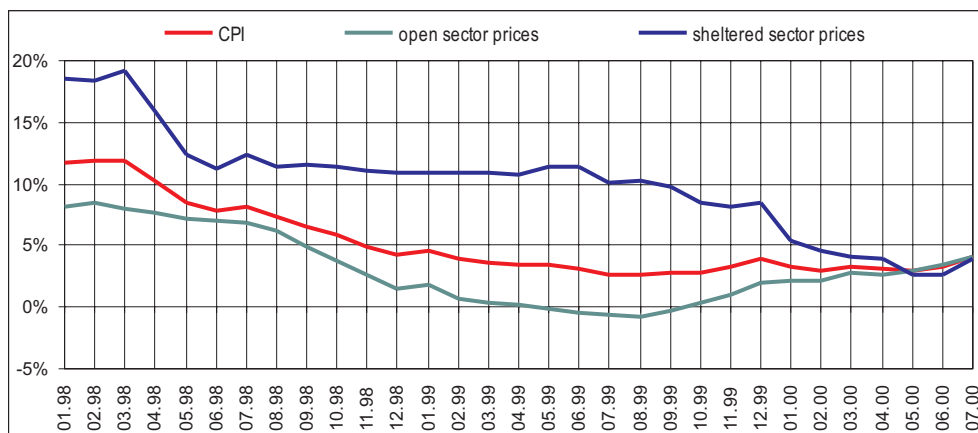


Figure 3.1. Twelve-month growth of CPI and its components

Most probably the slowdown of the price growth in the sheltered sector has hit “the bottom” in the second quarter and already in the second half-year prices of the sheltered sector will have their implications on inflation. The reasons are external pressure reaching via the open sector to the prices of the sheltered sector as well as administrative actions and demand. The recovered inflation can be considered conventional in a small open transition economy that has just left the recession cycle, especially against the background of continuously increasing external pressure.

Ever-growing external and domestic demand enhance potential inflationary pressure. The prices of dairy products, having recovered the early-1998 level after a major downfall, could move upward subject to the tripled EU export quota as of July. Although it looks currently that local dairies will not be able to meet the quota fully, it could become together with slowly recovering demand from the eastern market, one of the most significant food price trend agents.

Despite the modest price increase in the sheltered sector, the impact of the growing local demand can be traced as well. According to the real estate companies, the apartment prices in Tallinn suburbs have underwent a 5% growth on the average over the year, indicating the beginning of acceleration of real estate prices. The price growth is favoured both by favourable housing loan terms accompanied by continuously growing wages and new and simple financing possibilities like real estate leasing. Considering the continuously growing volume of the housing loan and a high demand for housing, surpassing supply in nearly all areas of Tallinn, real estate prices can still keep rising. The latter finds support in the fact that they have responded to changes in the economic cycle with an average delay of a year.

As factors currently neutralising inflationary external pressure will presumably be lacking in the near future, the dependence of the consumer price index (CPI) on the oil price and the exchange

rate of the US dollar will in the second half-year be much larger than before. Although rather the stabilisation of the nominal exchange rate of the US dollar or even a slight decline and stabilisation of fuel prices is expected, the current development has not confirmed such anticipation.

The short-term acceleration of inflation will probably not come to the end in the last months of 2000 but will rather be carried into the first half of the next year as well. **The upcoming period should be considered against the background of the previous economic downfall as the recovery of the normal price convergence process and as a short-term deviation from the downward trend of shrinking inflation variance with Western Europe in mid-term.**

REER and Competitiveness

Over the last couple of years the impact of the nominal exchange rate on the real effective exchange rate of the kroon has been unusually large. In terms of regular convergence the REER should reflect price differences in open and sheltered sectors but due to major fluctuation of nominal exchange rates significant "over-reaction" has taken place since 1998. After the devaluation of the Russian rouble in August 1998, the REER made a significant leap above the estimated equilibrium. Beginning from the last year the process has been reversed due to the weakness of the euro against the currencies of main trade partners and low domestic inflation (see Figure 3.2).

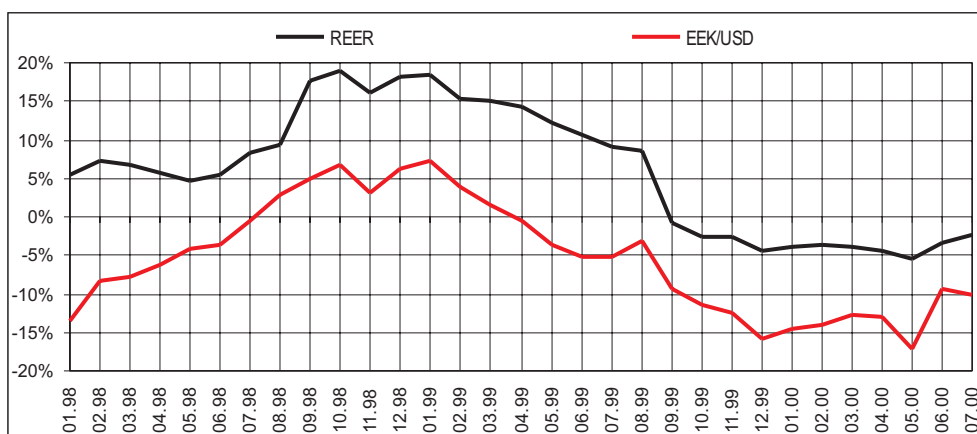


Figure 3.2. Twelve-month index of real effective exchange rate and change of EEK/USD exchange rate

During the first half of the year 2000 the REER has been about 4% below the year-ago level. For the first time since the restoration of independence of Estonia the real exchange rate developments have been favouring our competitiveness in external markets for such a long time. Nevertheless, we cannot say that the favourable real exchange rate of the kroon has brought along current large export volumes. Significant exports have been mostly achieved through structural changes in economy, making input-output volumes leap upwards. The price elasticity of external demand is of secondary importance.