III
INFLATION

Anticipated Acceleration of Inflation

In the wake of the economic downfall in the summer of 1999, the inflation was anticipated to accelerate. It did, although with a delay. In the first half of 2000 Estonian economy functioned under relatively low price increase whereas beginning from summer the price growth started significantly to gain space month by month compared to the last year (see Figure 3.1). In the third quarter consumer prices were 4.4% above the same quarter in 1999. Producer prices grew by 5.3, export prices by 7.2 and import prices by 6.4% during the same period.

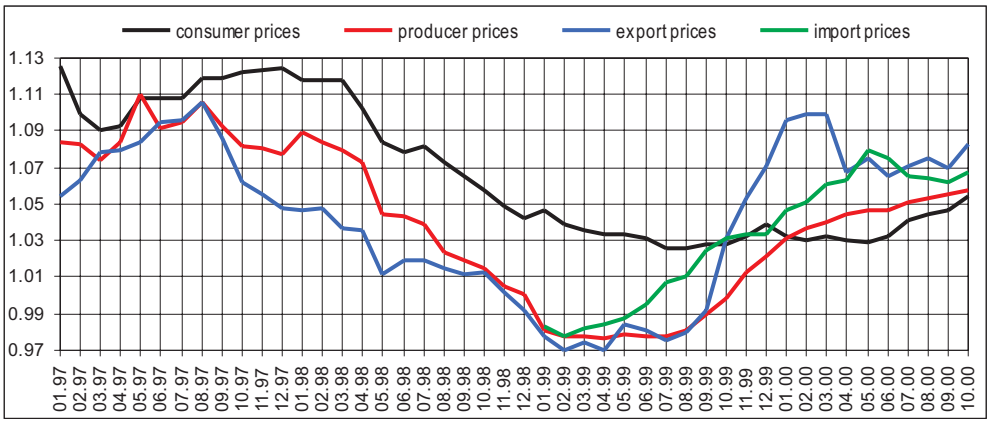

Figure 3.1. Twelve-month price indicies

This was mostly caused by external price pressure, although recovering domestic demand had its share as well. Nearly all of Estonia's major trade partners experienced the period of higher inflation in autumn. Thus, in September consumer prices in Finland were 4.3, in Great Britain 3.3 and in Germany 2.7% and in October producer prices in the United States 3.6% above the same month a year ago.

In the third quarter the inflation in Estonia was mainly subject to external factors (including the ongoing appreciation of the US dollar), an increase in administered prices and growing domestic demand. Developments in recent months indicate that inflation is switching to the path more characteristic of Estonia's economic development (ie prices grow by 2–3 percentage points more than in the euro-zone).

Considering the sustainable impact of external factors, adding intended rise in administered prices, no significant slowdown can be expected before the second half of 2001. There is nothing unusual there: the key factor influencing price developments in Estonia will be price convergence with the level of developed countries whereas convergence fluctuates, being periodically faster or slower than the trend.

The Trends of Key Indicators are in Compliance with Long-term Developments

The acceleration of the annual growth of prices in the **open sector** (4.4% in the third quarter and 5.3% in October against the same period in 1999) has largely been subject to external factors – the appreciation of foodstuff, oil and dollar on the world market.

The price dynamics of **foodstuff** in Estonia is similar to that of the euro-zone whereas the fluctuation range is wider (these goods depreciated in 1999 and appreciated in 2000 in Estonia more than in the euro-zone; see Figure 3.2). Foodstuff prices in Estonia are increasingly dependent on external prices. Estonia has clearly been a price taker in foodstuff prices but under price convergence and deepening economic integration external price changes and the difference between Estonian and foreign prices/quality will become even more decisive. In 1999 the depreciation of foodstuff prices was largely due to the collapsing Russian market and resultant excessive supply on the domestic market whereas in 2000 the opening of the European market (setting of sales quotas) has increased external demand and the impact of price fluctuations of foodstuff sold on that market. In summer the foodstuff exports were about 30% above the year-ago period, remaining still significantly below 1998 indicators.

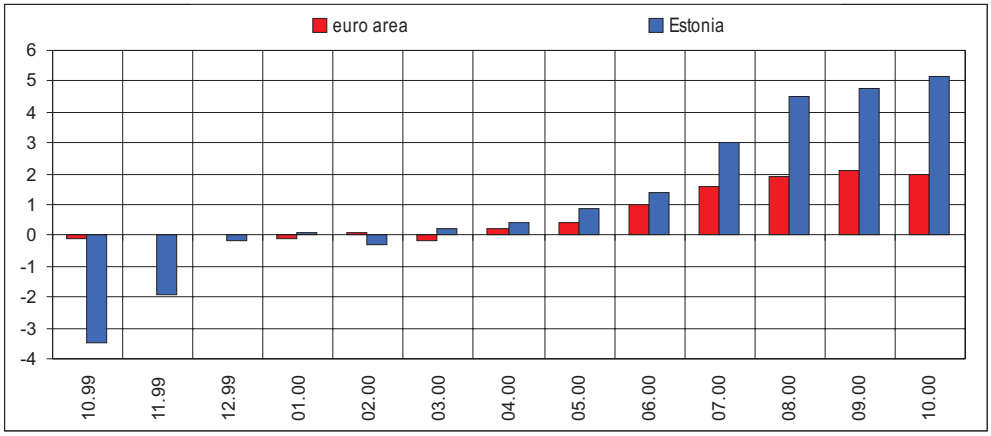

Figure 3.2. Twelve-month price change of foodsstuffs in Estonia and in the euro area (%)

Over the last two years the world **oil** price has gone up fast. This is considered one of the main reasons of the accelerating inflation both in the euro-zone and in the US. In Estonia motor fuel has appreciated by 38.2% over the last twelve months, being two thirds above the early-1999 level. Nevertheless, the increase in the motor fuel price can be considered relatively modest as the crude oil price has almost doubled in Europe during the last eighteen months. The price increases differ as, firstly, costs (excise tax, wages, other administrative costs) added to crude oil have not kept up in appreciation. Lower profit margins with which non-resident parent companies are satisfied in order to keep their market share in Estonia, as well as reserves, excluding the spread of each minishock, can influence too. Thirdly, an extensive current reorientation to Russian and Lithuanian fuel can inhibit a rise in the motor fuel price (an increase in the share of illegal fuel is possible as well).

Although motor fuel prices in Estonia are less turbulent than the crude oil price on European stock exchanges, major price changes make their delayed appearance here as well (see Figure 3.3).

The impact of the increasing oil price on Estonian prices is not only limited to the appreciation of motor fuel. The implication of this significant input on the prices of other benefits is only emerging whereas **the indirect impact of the appreciating fuel is long-term and more difficult to assess.**

Considering the specificity of economic sectors (reasons for price increases in the sheltered and open sectors are slightly different), one of the key trends could be manifest in the open sector price growth without considering the food and motor fuel prices. This indicator has changed more smoothly, reflecting lower disinflation in 1999 and lower inflation in 2000 than the price change in the entire open sector. It also displays some acceleration in price growth in 2000, although there is no reason for concern, taking into consideration the pressure arising from external factors and growing prices of other components, supported by domestic demand.

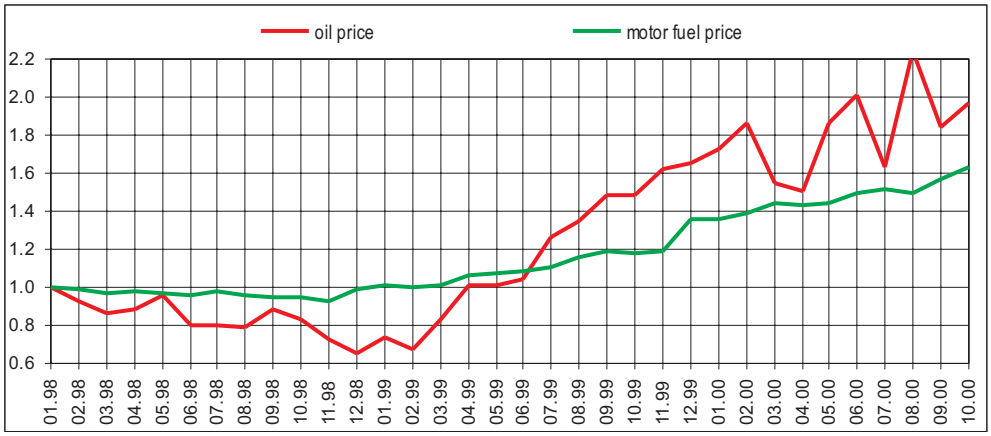

Figure 3.3. Oil price in Europe (in US dollars) and motor fuel prices in Estonia (in kroons; January 1998 = 1)

We can say that the 3–4% growth in key indicators reflecting price changes in the open sector is fully acceptable considering Estonia's level of development.

Due to the sustainable price convergence, price growth in the open sector (without food and oil prices as major sources of fluctuation) should remain within 3.5–4.0% in near future, exceeding the indicators in the euro-zone [1].

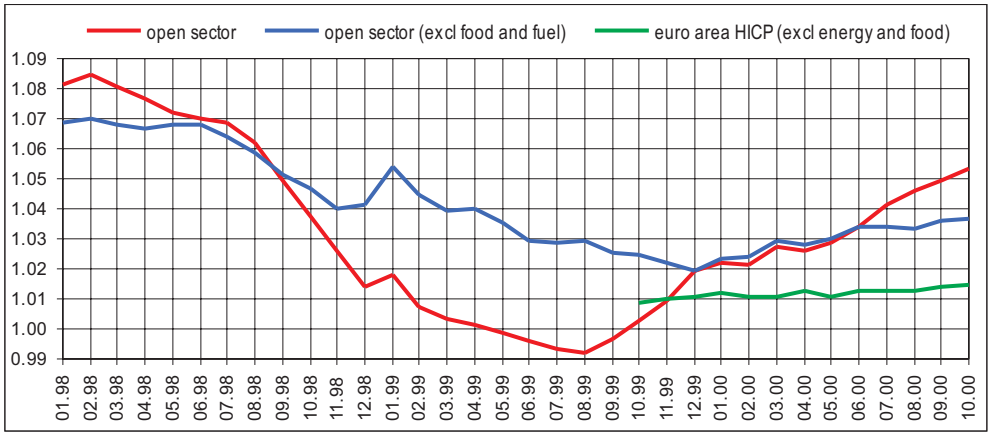

Figure 3.4. Open sector twelve-month price indices in Estonia and harmonised index of consumer prices in the euro area (HICP)

Until now relatively modest growth in sheltered sector administered prices has mostly compensated the external pressure on open sector prices but beginning from the summer of 2000 the growth is recovering (see Figure 3.5). Although during the last 12 months the growth of prices in the sheltered sector has been contained below those of the open sector, their annualised appreciation is still faster than in the open sector in 2000.

A significant part of sheltered sector prices comprises **administered prices**, raised in single actions. **The specificity of 2000 was maintaining the prices on their current level and the**

[1] It is not possible to use consumer price index (CPI) and open sector price index to characterise the entire euro-zone. There is the harmonised index of consumer price (HICP) there which differs from the regular consumer price index, including less components and using different calculation methodology. HICP can be quite unlike CPI. Eg in October 2000 British consumer prices were 3.1% above the year-ago period whereas HICP had changed only by 1%. Taking into consideration the above and using the harmonised index of consumer price with a certain reservation, we can say that price increase has accelerated slightly in the entire euro-zone. Thus, the movement of price indices in Estonia is not in conflict with the above (see Figure 3.4).

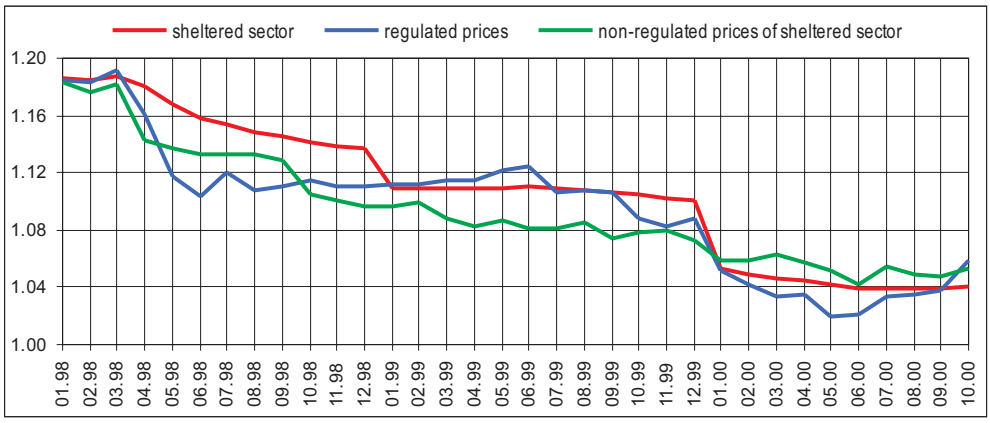

Figure 3.5. Twelve-month price index of the sheltered sector

accumulation of price increase decisions in the second half of the year and early 2001. The intended increase of administered prices (eg electricity, water and public transport passes) indicates a potential acceleration in sheltered sector prices in near future.

The non-administered prices in the sheltered sector displayed sustained slow disinflation in the third quarter. The anticipated acceleration of inflation of both in the open sector and in administered prices could have some pressure on the above prices as well.

Taking into account the ongoing convergence of prices in Estonia with the foreign price level and structure and the relative price disproportion, the preferential growth of the sheltered sector prices over those of the open sector in near future can be considered balanced.

Dynamics of Other Price Indices

Due to the openness of Estonia's economy, price changes of major trade partners have implications on our prices too. External prices and changes in nominal exchange rates of currencies influence domestic inflation primarily through export-import prices. The large share of foreign goods in final and intermediate consumption takes changes in external prices into Estonian prices, although with a time lag.

Estonia's export price dynamics follows price changes at our trade partners. Both the scope and the direction of fluctuations usually coincide (see Figure 3.6).

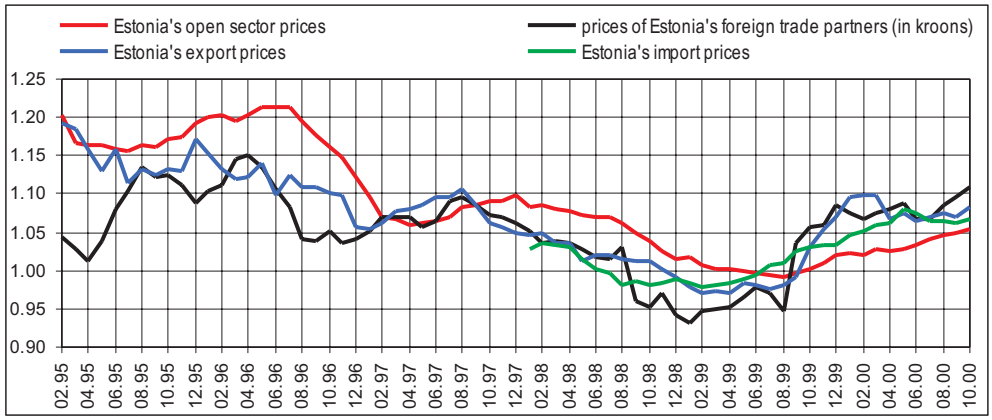

Figure 3.6. Twelve-month price indices of Estonia and our trade partners

Export and import prices leap sharply quite often in Estonia as a small country. Due to small number of export-import companies, changes in a large company's contract can have a significant impact on the price index. Therefore monthly price indices do not reflect the reality quite adequately.

Considering longer-term (12 months) dynamics of Estonia's export and also import price indices, a clear trend of price growth acceleration in 2000 is manifest (see Figure 3.7).

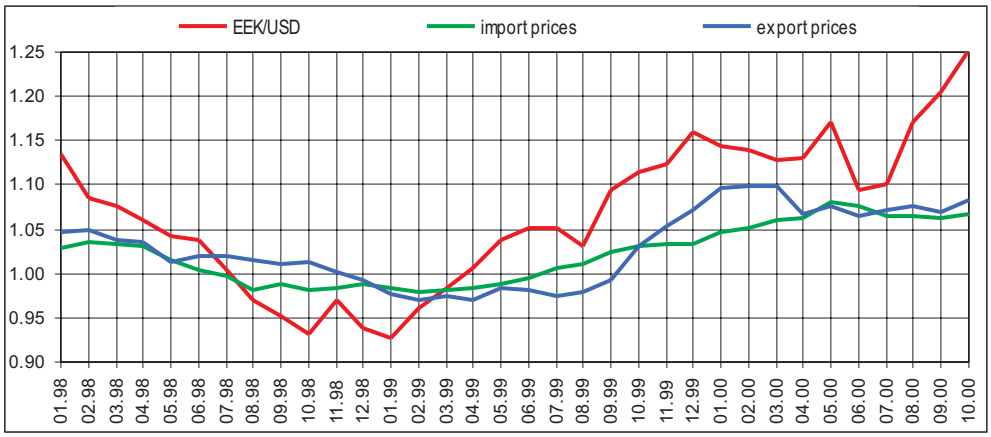

Figure 3.7. Twelve-month index of the US dollar and Estonia's export and import price indices

Comparing changes in export and import price indices between themselves, we have seen improvement in terms of trade since July. Ten months display that export prices were an average of 8.0% and import prices of 6.4% above the same period in 1999. Thus, residents should get more imported goods for an equal amount of exported goods. The more favourable price environment could also contribute to Estonia's economic growth, applying simultaneously pressure on domestic prices.

***Summa summarum* we can say that Estonia's temporary inflation rate acceleration, commencing in the third quarter, is sustainable. The impact of external factors on foodstuff and motor fuel, sustained appreciation of the dollar, accelerating growth of administered prices and growing domestic demand have been and still are the main reasons. The inflation is getting to the level more in compliance with Estonia's development.**

REER and Competitiveness

Regardless of the accelerating inflation in Estonia the real effective exchange rate of the kroon computed from consumer prices has revealed a sustainable downward trend throughout the last year (eg 3.6% in the third quarter of 2000). Herewith we can talk about relative strengthening of Estonia's price position (acquiring additional competitive advantages) which would simultaneously mean additional pressure on prices in Estonia.

In the third quarter the real exchange rate of the kroon against the currencies of developed countries did not really change (see Figure 3.8). The sustained growth of the nominal exchange rate of the dollar offset price growth in Estonia. **The suspension in the depreciation of the euro in October-November and further appreciation and increasing inflation spread between Estonia and the euro-zone mean a rise in the real exchange rate of the kroon against the currencies of developed countries in immediate future.**

The real exchange rate of the kroon against the currencies of the transition economies dropped by 13.3% in the third quarter. The spare competitive advantages of Russian prices gained from

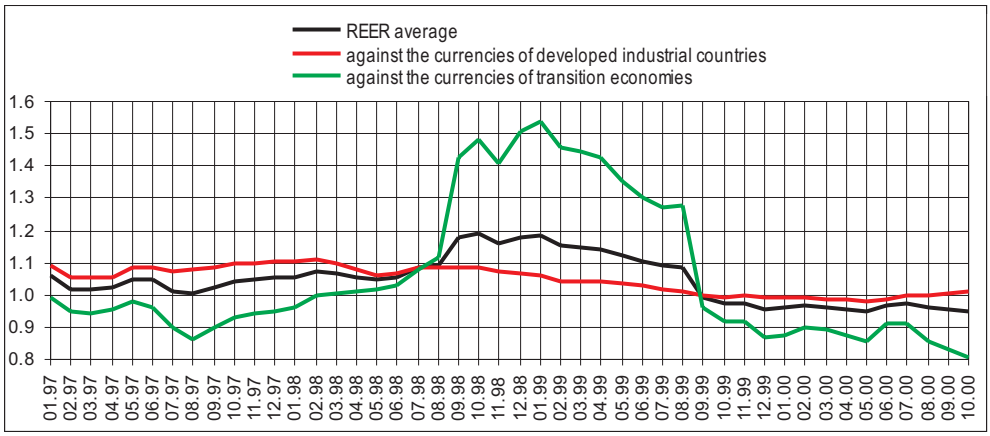

Figure 3.8. Twelve-month index of real effective exchange rate of the kroon

the fall of the nominal exchange rate in autumn 1998 is nearly exhausted (in Estonia the prices are about 15% higher whereas a year ago the gap was close to 52%). In 2000 prices in Russia have displayed a preferential growth against prices in Estonia: in the third quarter the real exchange rate of the rouble against the Estonian kroon grew by nearly 18%. This was due to faster inflation (in the third quarter consumer prices in Russia were about 18.8% above the same period in 1999 whereas in Estonia only 4.4%) and a 3.5% growth in the nominal exchange rate of the rouble.

The situation is slightly different as regards Latvia and Lithuania. Already during several years the real exchange rate of the currencies of these countries has been significantly above that of the Estonian kroon, providing us an advantage in international competition. In the third quarter of 2000 the above trend deepened even further. Whereas both in Latvia and Lithuania consumer prices grew less than in Estonia (in Latvia by 2.8% and Lithuania 0.9% against the third quarter of 1999). The dollar peg of the lats and the litas has pushed the nominal exchange rate of these currencies significantly upward (by 13% of the lats and 15.7% of the litas against the Estonian kroon). In conclusion the real exchange rate of the kroon decreased by 10.1% against the lats and 10.7% against the litas in the third quarter.