

III INFLATION

Slowdown of the Price Increase

After nearly nine months of fluctuations between 4–5% Estonia's annual inflation rate slowed down considerably this summer (see Figure 3.1). The lowering of the inflation rate was supported by the significant weakening of the pressure on food prices as well as other external factors (fall of fuel prices and weakening of the US dollar).

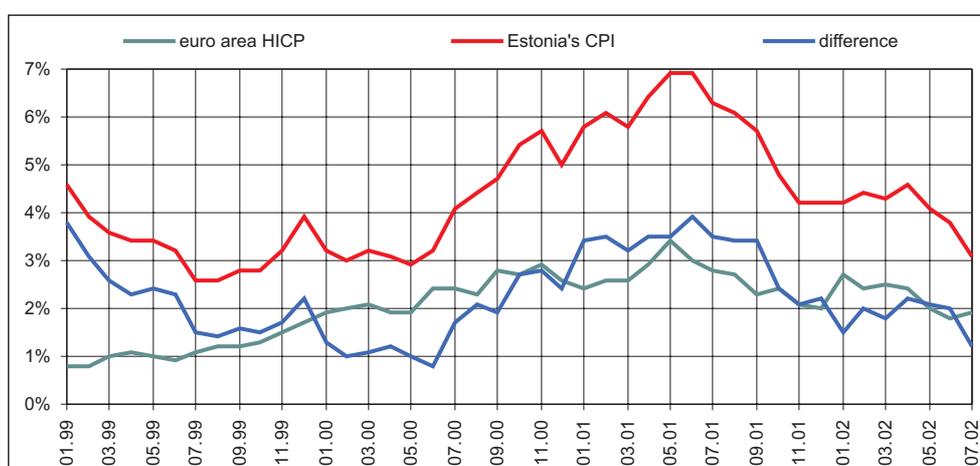


Figure 3.1. Annual growth of consumer prices in Estonia and euro area

The European Central Bank predicts the euro area inflation to remain around 2% in the coming months. It is noted that although the strengthening of the euro, weak external demand and lower pressure on food and fuel prices could bring inflation down, rapid growth of wages, the dynamics of the prices of services and the monetary policy environment increase inflationary pressure. Therefore, no significant slowdown of price increases is foreseen in the future and the average annual inflation rate is expected to reach 2.1%.

In Estonia, the July 3.1% increase of consumer prices was one of the lowest since the restoration of independence. Difference from the euro area inflation was also smaller than usually (1.2 percentage points). As no rapid fall of the inflation rate is expected in Europe in the near future, the bottom of the Estonian price increase is likely to be in the third quarter this year.

The slowdown of the consumer price increase in Estonia results mostly from external developments. The weakness of the global demand environment has influenced Estonian food export more than had been expected. Combined with the lower pressure on food (in Europe) and fuel prices, this has a slowing effect on the increase of prices in Estonia.

Since the 2001 acceleration of the inflation rate was to a large extent caused by external factors of temporary nature (price increase of energy and related goods and services, and food) it is only natural that in 2002, when the impact of these factors has faded away, the price increase should slow down as well. The annual increase of the consumer prices was over two times smaller this July than it had been in July 2001 (3.1% and 6.3%, respectively). 75% of this

slowdown resulted from the fall of the food price increase (from 9.8% in 2001 to 1.6% in July 2002) and 25% from changes in the price of motor fuels (last July the price of fuels increased by 0.4%, while this July decreased by 0.5%). The increase and impact of the prices of administratively regulated and other utilities remained broadly on the level of last year (see Figure 3.2).

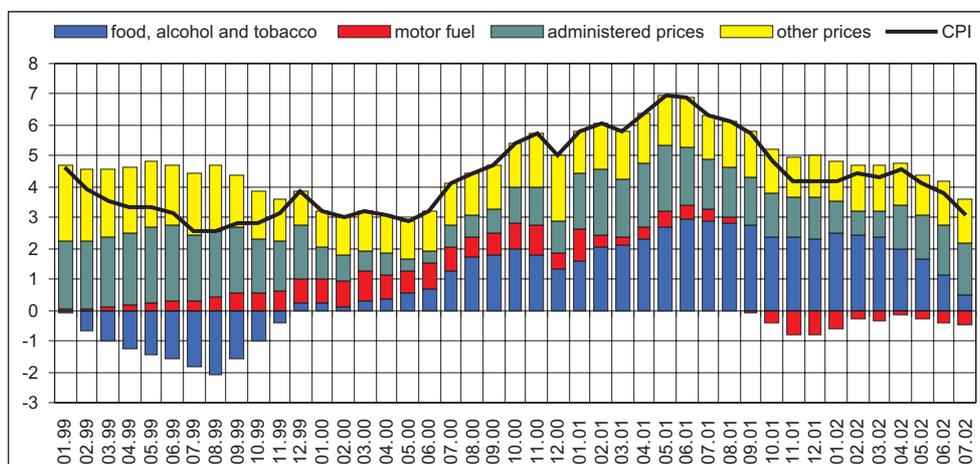


Figure 3.2. Annual change of consumer price components (percentage points)

In the past 18 months the increase of food prices has been the weightiest inflation factor (accounting for over 40% of the total increase), while in the second quarter of 2002 the increase of food prices continued to slow down, accounting for just 14% of the overall consumer price increase in July. Despite the fact that the increase of food prices in Estonia is currently slower than in the euro area (in July, food prices were up 2.1% in the euro area and 1.6% in Estonia), the increase of food prices can slow down even further in the coming months. This is indicated by the fall of the respective component in other price indices which usually precede changes in consumer prices: year-on-year producer prices of food fell by 3.2% in July, import prices decreased by 5.4% and export prices were down 11.5%. However, the opposite pressure can originate from the aftermath of the Central European floods in Central Europe. At the same time, the annual increase of other consumer prices has been rather stable over the past 18 months. As the rate of the so-called underlying inflation¹ has been higher, a considerable slowdown of the overall inflation rate is unlikely in the near future.

Changes in the Real Rate of the Kroon

The increase of the real effective exchange rate of the Estonian kroon, based on consumer prices, accelerated in the second quarter, regardless of the slowdown of the inflation rate. The range of impact of the change in the nominal rate of the kroon increased and the share of inflation differences decreased. Changes in the nominal rate mostly resulted from the depreciation of the US dollar against the euro. The nominal rate of the kroon fluctuated more than the real rate, but the duration of these fluctuations is shorter. However, the annualised seven month average real appreciation was not too rapid (1.5%).

Against the currencies of transition countries, the average annualised weakening of the real rate of the kroon amounted to 0.4% in seven months, although in the last three months the real

¹ The more volatile prices of motor fuels and food have been excluded from the sample used for calculating the underlying inflation.

rate increased by an average of 6%. The strengthening of the kroon was mostly caused by changes in the nominal rate².

The strengthening of the kroon was more even against the currencies of industrial countries – 2.3% on average. The following differences across the countries were registered:

- the increase of the real rate of the kroon against the euro area countries slowed down as the difference between the inflation rates of Estonia and the euro area diminished;
- the annual increase of the real rate of the kroon against the US dollar amounted to 8.1% in the second quarter, reaching even as high as 12.5% in July. This was mostly due to changes in the nominal rate (in July, for example, the nominal rate of the kroon was 10.9% higher year-on-year);
- the real rate of the kroon fell 0.6% against the Swedish krona in July, while the nominal rate decreased by 1.5% and the difference between the inflation rates of Estonia and Sweden amounted to one percentage point.

The dynamics of the nominal rates of currencies (the euro/dollar rate, first and foremost), which has been a weighty component in the strengthening of the real rate of the kroon, indirectly affects the development of the Estonian inflation as well. The recent strengthening of the euro can thus mean the weakening of price increase pressure in Estonia (see Figure 3.3).

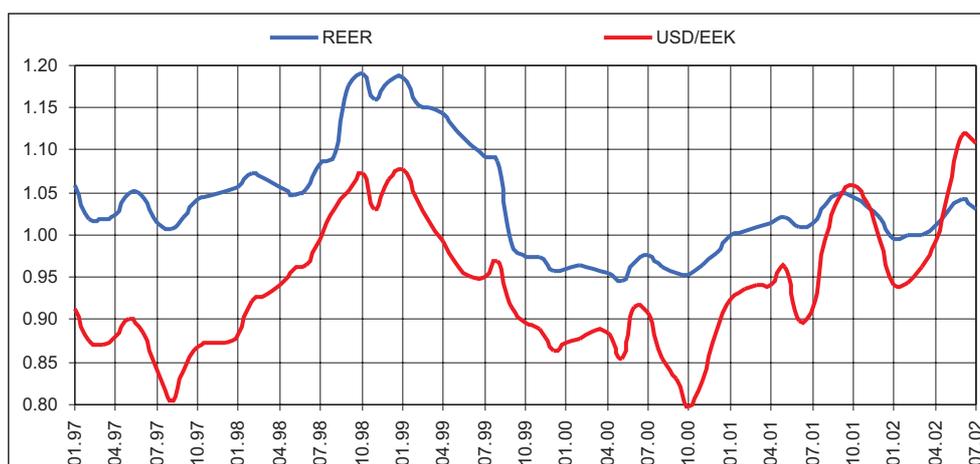


Figure 3.3. Twelve-month indices of real exchange rate of Estonian kroon and nominal exchange rate of US dollar

From the point of long-term price convergence process, the annual increase of the real rate of the kroon has been moderate in the first seven months of 2002 and close to the equilibrium level. In the short term, the effect of the nominal rate fluctuations has increased.

² In Russia, the annual increase of consumer prices reached 15.1% in July, exceeding the respective indicator of Estonia by 12 percentage points. At the same time, the nominal exchange rate of the rouble fell by 19.2%, of which two thirds resulted from changes in the exchange rate of the dollar.