

III

INFLATION

Consumer Price Index

The second half of 2003 saw the end of the slowdown of the consumer price increase, which was replaced by a moderate acceleration. The quickening of the inflation rate from 0.7% in the second quarter to 1.2% in the third quarter was logical after the interim decline of food and fuel prices. Still, inflation remained lower than in the euro area (see Figure 3.1). The decrease of the inflation rate to 1.0% in October-November did not affect the inflation growth trend for the coming months. The annual increase of consumer prices amounted to 1.3% in 2003, which is the lowest annual average since the restoration of independence.

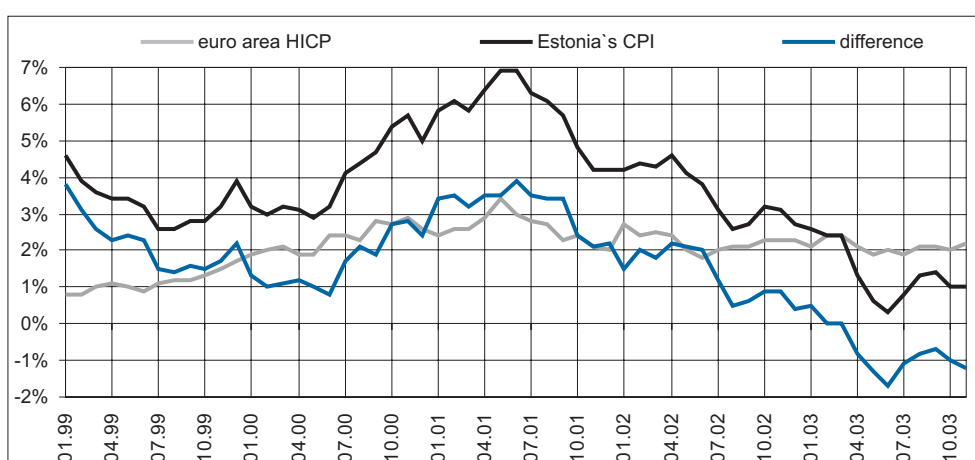


Figure 3.1. Annual growth of consumer prices in Estonia and euro area

Like in the euro area, inflation rate in Estonia was mostly determined by food and oil prices, as well as by administratively regulated prices (see Figures 3.2 and 3.3). The deceleration of the consumer price increase in Estonia was caused mostly by external factors. The weakness of global demand and US dollar was expressed in import prices, which also affected other prices in Estonia. First of all, this could be seen in the lower increase of producer prices and the majority of export prices, which in turn affected consumer prices.

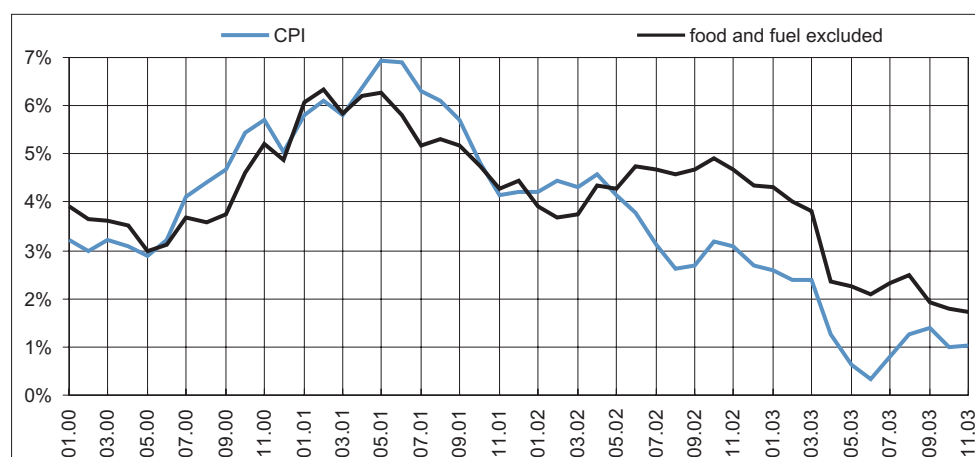


Figure 3.2. CPI growth

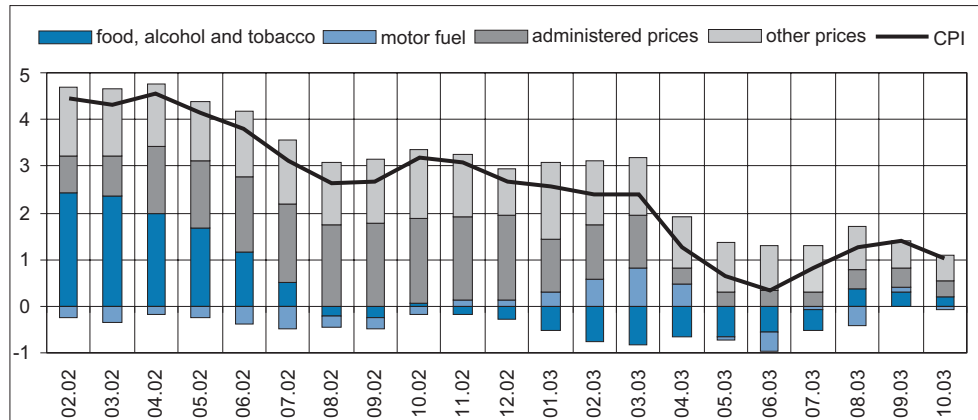


Figure 3.3. Annual change of consumer price components (percentage points)

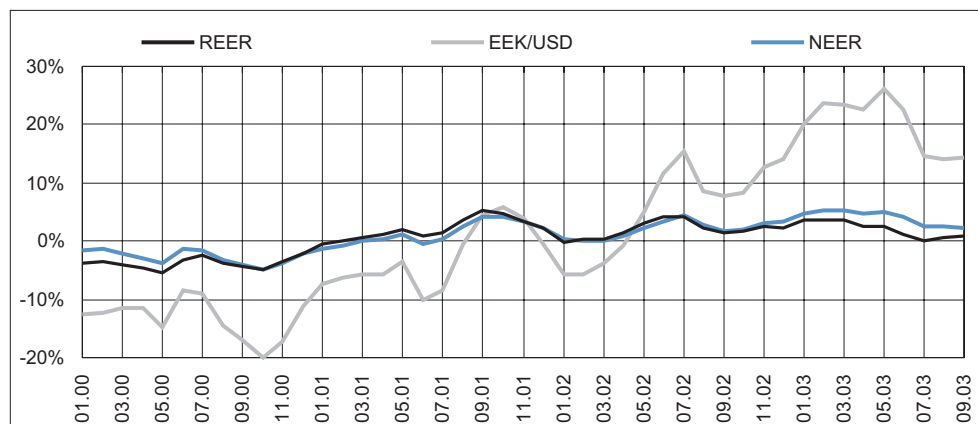


Figure 3.4. Annual change of real (REER) and nominal (NEER) effective exchange rate of the Estonian kroon

While the slowdown of the inflation rate in mid-2002 was mostly attributed to the fading impact of external factors of temporary nature (the increase of food prices came to a halt and fuel prices decreased), then in 2003 disinflation or the slowing of the rate of price increase was caused, first of all, by cheapening of food products. High volatility of fuel prices in 2003 was transferred to the prices of other goods and services, although the annual impact remained small. The impact of administratively regulated prices was 2.5 times smaller in 2003, partly due to political reasons (parliamentary elections). At the beginning of 2004, inflation rate is expected to accelerate first of all due to new administrative price regulations and towards the end of spring due to the increase of several excise and VAT taxes.

Real Exchange Rate of the Kroon

Regardless of the acceleration of the inflation rate, the appreciation of the real effective exchange rate of the Estonian kroon, calculated on the basis of consumer prices, dropped from 2.1% in the second quarter to 0.5% in the third quarter, which is the lowest level ever. The impact of the change in the nominal exchange rate of the kroon increased and the share of inflation differences declined (see Figure 3.4). Changes in the nominal exchange rate of the kroon were mostly related to slower appreciation of the euro against the US dollar – the annual increase dropped from 23.8% in the second quarter to 14.4% in the third quarter.

From the point of long-term convergence of prices, the 2.1% increase in the real exchange rate of the kroon in the first ten months of 2003 was moderate and balanced as compared to the same period of 2002.