III
INFLATION

Consumer Price Index

Consumer price index decelerated expectedly from the first quarter's 4.6% to 3.5% in the second quarter of 2005. This can be explained mainly by technical measurement issues, namely the dropping out of the previous year's low comparison basis rather than the price changes of the last few months.

The inflation development of July no longer met forecasts as well as expected. Due to the oil price rise the consumer price growth accelerated to 3.8%. The slightly greater than 1.5 percentage point difference compared to inflation in the euro area may be considered a natural price convergence indicator in Estonia in the long run, but in a shorter perspective it exceeds the desired level in the light of fulfilling the Maastricht inflation criterion (see Figure 3.1).

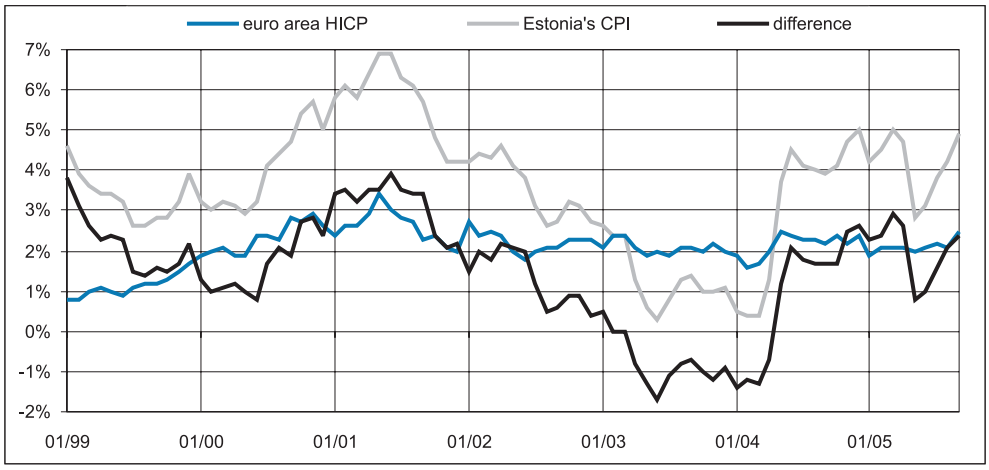

Figure 3.1. Annual growth in consumer prices in Estonia and in the euro area

High and fluctuating oil prices have affected price developments significantly all over the world. Also in Estonia, motor fuel prices have become the most influential inflation factor. In September when consumer price growth stepped up by 2.1 percentage points compared to May, i.e. to 4.9%, 90% of the increase was caused by the acceleration of motor fuel price growth up to 34% in September. In September, 49% of the consumer price growth was induced by the price increase of motor fuel.

Although the new temporary inflation rate rise was caused mainly by growing in motor fuel prices, which is considered a one-off factor, a slight acceleration in core inflation could nonetheless be noted already in July and August.

The Estonian core inflation indicator has been exceeding that of the euro area since February and in August the spread between them grew up to 0.8 percentage points. In August, Estonian

core inflation accelerated by 0.3 percentage points, the while euro area core inflation slowed down to historically low levels. In Estonia, the oil price rise also caused other prices to increase and the growth in domestic demand supported the continuation of the customary price convergence (see Figure 3.2).

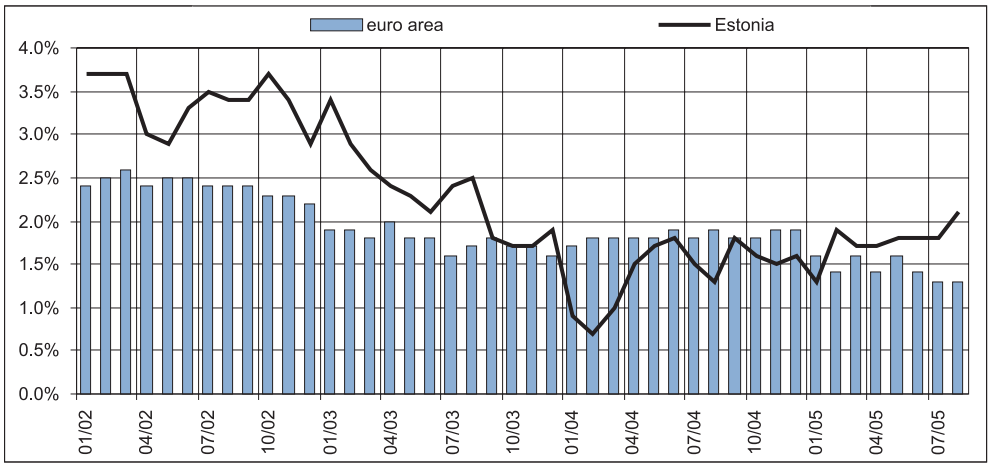

Figure 3.2. Core consumer price inflation (all components, except food, alcohol, tobacco and energy)

Source: Eurostat

A more thorough analysis of the core inflation components showed that 75% of the core inflation acceleration in the third quarter of 2005 was caused by transport services, which can be considered an indirect impact of the rise in motor fuel prices. To a lesser extent, the core inflation was also affected by an increase in housing costs and the price increase of clothing and footwear (see Figure 3.3).

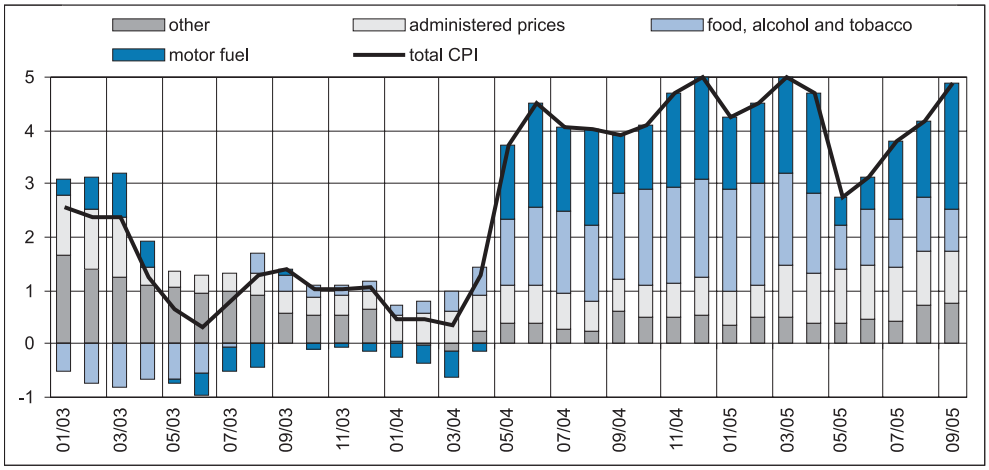

Figure 3.3. Absolute contribution of components to CPI inflation (in percentage points)

All in all, due to continually rising oil prices the expected decrease of inflation is turning out slower than initially forecast.

Labour Costs

In the second quarter of 2005, the average gross monthly wages was 8,291 kroons, meaning that the nominal annual growth accelerated up to 11.8% from 10.1% in the first quarter. Though the average gross hourly wage increase slowed down, it still reached 11.1%. While average gross hourly wages only include the pay for the time worked, the average gross monthly wages include the pay for the time actually worked as well as for the time not worked, i.e. all payments calculated on the basis of average pay, bonuses and compensations (e.g. maintaining the pay during vacation). The faster growth of gross monthly wages compared to gross hourly wages indicates a year-on-year increase in additional remuneration and vacation payments.

The rapid rise in wages continued in the fields of hotels and restaurants, reaching a year-on-year level of 20.9% in the second quarter. Wages increased nearly as fast in health care and social welfare, and also in construction and agriculture. In the public sector, however, the rise in wages slowed down from 10.1% in the first quarter to 7.4% in the second quarter. Wages in the mining industry still continued decreasing and thus the average wages in the second quarter were approximately 2% smaller than a year ago.

As to counties, the growth in wages was the greatest in Jõgevamaa and Järvamaa where the average wage level is relatively low – 24.7% and 17.8%, respectively. In Harjumaa, where the average wage level is the highest, the rise in average wages remained below the Estonian average for the seventh consecutive quarter.

Since the consumer price inflation of the second quarter was lower than in the first quarter, the increase in real wages accelerated up to 8.0% along with nominal growth.

While in 2004 raising the non-taxable income threshold enabled employers to restrain labour cost growth without aggravating the situation of employees, as the growth of employees' net wages did not decelerate (i.e. employers benefited the most from lowering the personal income tax), the tax changes of 2005 exerted a positive influence on the situation of employees. Thanks to lowering the personal income tax rate from 26% to 24% and raising the non-taxable income threshold from 1,400 to 1,700 kroons the increase in net wages exceeded the rise in gross wages by more than 2 percentage points, which may entail a faster private consumption growth.

Unit labour costs in Estonia decreased until 2002; however, in 2003 the trend turned. This was associated with the lower than expected GDP growth and its impacts on wage formation that became apparent after a certain period. During 2004, due to the recovery of economic growth the increase in unit labour costs slowed down again, which was followed by an expected decline. The share of the wage fund in the GDP (i.e. changes in real unit labour costs) decreased to an annual total of 0.9% compared to the previous year. Meanwhile, it was more difficult to draw conclusions on the dynamics of the share of unit labour costs and profit in 2004, because in 2004 several resources from the European Union structural funds were added to the revenue side of the GDP, which increased both the share of the wage fund as well as of the profit in the GDP.

In the first half of 2005, unit labour costs remained approximately at the same level, year-on-year, despite the accelerated growth of employment and wages (see Figure 3.4).

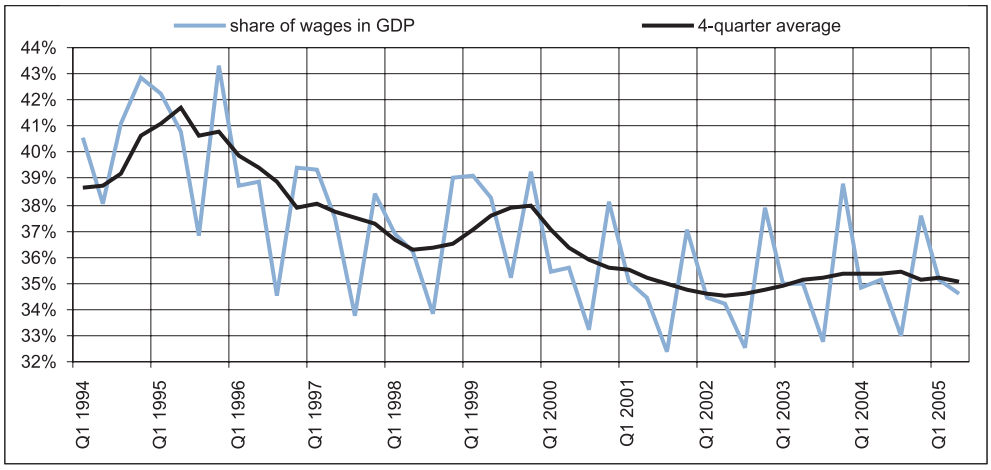

Figure 3.4. Share of wage costs in the GDP structure

Real Exchange Rate of the Kroon

Even though Estonia's inflation rate accelerated in 2005, the growth rate of the real effective exchange rate of the kroon[1] was not as substantial. The nine-month increase in the real exchange rate of the Estonian kroon against the currencies of our major foreign trade partners reached 1.4%, year-on-year; in 2004, though, the real exchange rate of the kroon increased by 1.3% on average (see Figure 3.5).

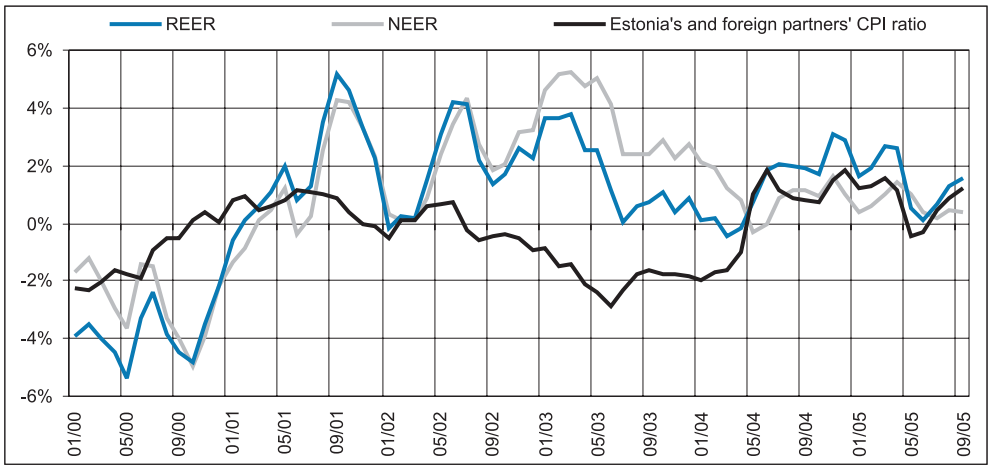

Figure 3.5. Change in the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

The distribution of major trading partners into two groups – transitional countries and industrial countries – derives from the fact that while there is price competition between Estonia and transitional countries (due to a similar price level), the prices of industrial countries still remain

[1] The index of the real effective exchange rate (REER) of the kroon describes exchange rate changes of the kroon against the currencies of Estonia's nine main trading partners and the changes in Estonia's consumer prices against the changes in the consumer prices of these trading partners. It is based on the structure of Estonia's foreign trade turnover.

lower than in Estonia and a rise in the real exchange rate may be regarded as an indicator of the price convergence.

Within nine months the exchange rate of the kroon rose by an average 3.2% against the currencies of industrial countries, which is slightly more than usual. The main influential factors were the acceleration of inflation in comparison with the euro area and the further increase in the kroon's nominal exchange rate against the dollar. Though the increase was slower and its extent remained smaller than in 2004, in nine months the exchange rate of the kroon nevertheless increased by an average 3.1%, year-on-year. The Estonian kroon primarily appreciated against the currencies of other new European Union Member States due to rapid inflation. However, within the first nine months of 2005 the kroon depreciated against the Russian rouble by 7.2%.