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Trying to Please Big Spenders and the Budget

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The beginning of 2011 was marked by a number of events that had a serious impact on the markets and global economy.

The unrest in North Africa and the Middle East, which in some cases led to a change in political regime, along with the earthquake and tsunami in Japan were stark illustrations that the world has become a much riskier place.

The full impact of the nuclear disaster in Japan has yet to be seen, and it is too early to assess the immediate impact of the catastrophe on the Japanese economy and the global economy as well. But it is already clear that energy policy in major energy-consuming countries will undergo a substantial transformation, which will in turn affect the future geopolitical and economic landscape.

The perception of risk of a disruption to the supply of fossil fuels and nuclear energy has

increased, and it is so far unclear how it will be reduced in the long term. Hence, greater market volatility amid higher prices is becoming the new norm in a very broad sense, though volatility should not necessarily be high across the board.

In Russia, the overall risks of high inflation are quite high. Global food price inflation will likely affect Russian consumers, even though Russia is less dependent on food and commodity imports than many other countries.

But these risks are manageable. Many countries with a larger share of foodstuffs in the consumer basket have been able to hold inflation at a lower rate than Russia. That said, the country's accelerated inflation in late 2010 and in January seems to be largely homegrown. Indeed, the Central Bank's interventions on the foreign-exchange market and overly generous budgetary spending caused prices to rise steadily in the past five months. Indeed, food prices soared in the first 10 days of January, with double-digit inflation for potatoes and cabbage that cannot be explained by global increases in potato and cabbage prices. At month-end and in early February, food price inflation eased as the effect of the December spending gradually dissipated.

Many countries raise budgetary spending in December, but not as much as Russia. In December alone, the government spent 17.5 percent of its annual budget, while the U.S. government spent about 9.2 percent of its annual sum, and such uneven spending illustrates the extent to which Russian budgetary expenditures are inflated. A more even allocation of budgetary funds would result in monthly installments of about 8 percent of the annual budget. That said, it looks as if 8 percent of the public spending is excessive. Unsurprisingly, inflation remains at about the same level in Russia. Paradoxically, high oil prices these days help contain inflation because the corresponding increase in federal tax revenues on oil sales helps shrink the budget deficit.

Given that inflation in the United States is not considered an acute problem — it was only 2.1 percent on a year-to-year basis in February— near-term U.S. macroeconomic policy will most likely be neutral in the sense that the Federal Reserve will stay on hold with respect to policy rates. At the same time, there is a greater chance that other central banks, such as the Bank of England (not to mention those in smaller and faster-growing economies) will have more incentive to raise rates in the foreseeable future. Even the European Central Bank may raise rates at some point this year, which was already hinted at by policymakers. In any case, it looks likely that the European Central Bank or the Bank of England may eventually start raising rates earlier than the Federal Reserve, which may also become a new normal practice.

An increase of policy rates by 0.25 percent — or even 0.5 percent — will not affect growth in European countries much, but they may influence capital flow. The role of the dollar as a carry-trade currency will increase, implying its further weakening by year-end, assuming no major geopolitical turbulence occurs spurring investors to run for safety. In the meantime, potential strengthening of the pound sterling and euro will help reduce inflationary pressure in Europe as costs of commodity imports, including soft commodities, will be suppressed. The United States may be forced to raise rates later if inflation accelerates, particularly since a weaker dollar will inevitably keep commodity prices high and keep the U.S. current account in the red zone.

Potentially widening interest rate differentials will have a greater impact on currency markets than on bond markets. Should there be an increase in currency carry trade, in which a currency with a relatively low interest rate is used to purchase a different currency yielding a higher interest rate, bond yields may not go up significantly, especially given that the consolidated budget deficit in the euro zone as a whole is expected to be smaller than that in the United States. Overall, should interest rate policies in Europe and the United States diverge, volatility on currency markets could see a hike, as opposed to the current relative stability.

Expected dollar weakness will be accompanied by relatively high commodity prices, which is a rather comfortable environment for Russia. In the past, a rising oil price was always accompanied by rapidly climbing budgetary expenditures, implying high inflation, real appreciation of the ruble and a growing dependence of the budget on crude. That was the old norm. Given that the breakeven price of oil is about $105 per barrel, Russia's new norm should imply no major increase in budgetary spending in nominal terms. Whether this will be the case has yet to be seen, as the enthusiasm of the pro-spending camp within the policymaking elite usually rises faster than the oil price.

Nonetheless, pressure on the expenditure side of the Russian budget is very high these days. If budgetary spending is amended this year but still expands less than 10 percent — a realistic assumption that corresponds with the rate that nominal gross domestic product is expected to grow — Russia will still remain in the comfort zone.

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The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.

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