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Dmytro Boyarchuk, Viktor Skarshevsky & Vladimir Dubrovskiy

EXECUTIVE SUMMARY

The economy is clearly overheating, with the CPI climbing past 26% in March, but real growth falling to 6% by the end of Q1, from 8% 12 months before. We've now think CPI will rise by nearly 25% for the year. Inflation has defied all expectations of leveling off. Top officials have tried to blame opponents and imaginary enemies, and the Central Bank is only timidly tightening. But all symptoms point to booming demand as the key reason for the inflation surge. Wage inflation, skyrocketing consumer prices and significant domestic demand all underscore the situation. With 2009 presidential elections hanging in the balance, there's virtually no chance for a soft landing, let alone mitigation of rising gas prices. Ukraine is likely to "enjoy" galloping inflation for another year or two.

But we don't see significant risk, so far, of stagflation, as the economy continues to benefit from the global rises in fuel and natural resource prices. Metallurgy, chemicals and agriculture will be the vehicles bringing prosperity into the country in the near future. So we expect strong real sector performance, too, and stand by our forecast of 6.5% real GDP growth for the year.

The unhealthy price distortion will probably work out through the exchange rate, and the Central Bank is likely to devalue the *hryvnia* over the next two years. The rapidly increasing trade deficit has no chance of reversing under such powerful consumption growth. Investment inflow has been the only safety belt so far. But it can't last forever: we think that story is likely to end by 2009.

GlobalSOURCE
641 Lexington Avenue
18th Floor
New York, NY 10022
Phone: 212-317-8015

info@globalsourcepartners.com
www.globalsourcepartners.com