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UKRAINE
MONTHLY REPORT

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The Inflation Bomb

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EXECUTIVE SUMMARY

The announcement of a series of dramatic social spending initiatives, such as expansion of pension benefits, a program to begin repaying savings lost in the collapse of the Soviet Union, and higher child care benefits, have people chatting excitedly. But these crowd-pleasing programs – we think intended to boost Prime Minister Yulia Tymoshenko's potential candidacy in the 2009 presidential elections – portend an inflationary bomb.

If carried out, such programs will double social spending, and dash any hopes of reining in inflation this year. In fact, it now looks as though the CPI will climb beyond 17% in 2008, from 2007's 16%.

Tymoshenko is simultaneously pursuing a gutsy bid to shake Ukraine lose from heavy dependence on Russian gas – and is also counting on financing part of her expensive social program by expanding privatization, and speeding up sales. That's good news for foreign investors: since the money is so necessary, they can expect to be welcomed, and that the privatization process will be transparent. They also may find they have some negotiating power on price. The government has set forth a provisional list of assets, and is likely to sell them by the end of March.

Underlying Tymoshenko's challenge to Russia's Gazprom is her effort to keep a campaign promise to avoid raising household gas prices, despite the rise in the cost of gas imports. She's attempting to break up an arrangement whereby Gazprom profits, but Ukraine's nearly bankrupt Naftogaz is forced to subsidize domestic household rates, which in turn must be paid for by the Ukrainian budget. If she fails, though, energy tariffs could rise about 10% in H2, since the budget won't be in a position cover these losses.

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