

CONTENTS

NATO Issues Spark a Political Crisis

Gas Standoff with Russia-Not a Done Deal

Worrisome Signals in the Real Sector

Inflation: Nothing to Be Done

Budget Looking Good

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Worrisome Signals

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EXECUTIVE SUMMARY

A political crisis instigated by the PR-led opposition over the government's interest in joining NATO seems to have backfired, as the effort to shut down Parliament was followed by falling approval ratings for the opposition. Parliamentary activities remain frozen, but we think the protest will soon be abandoned, as opposition-linked business leaders and elites are backing away from it. Prime Minister Yulia Tymoshenko and her BYuT party, however, seem to have gained.

A standoff with Russia over its threat to reduce natural gas exports to Ukraine over \$1.5 billion in arrears is unlikely to be resolved by a deal between President Viktor Yushchenko and Russian President Vladimir Putin. This is because the way it was arranged seemed deliberately engineered to lionize Yushchenko, perhaps to the detriment of Tymoshenko. Tymoshenko will never back Yushchenko's promise to keep Russian intermediary firms in Ukraine. In this, she has the public on her side: if she's forced to take a stand, and loses her job, she'll be a hero – putting herself in a powerful position ahead of the 2009 presidential elections.

The economic outlook, meanwhile, is worsening. GDP growth plunged to 4.9% in January, after growing 7.3% in 2007. Declines in metallurgy and oil refinery output were the main reasons for the slowdown. We see these slowdowns as temporary, driven by a shortage of inputs. More disturbing was a -9.6% contraction in construction, typically a reliable indicator for weakening investment sentiment.

Inflation kept accelerating, as we projected. CPI rose 2.9% in January (19.4% y/y), still smarting from the weak 2007 harvest. The government and monetary authorities are making inflation-fighting plans, but instruments can target only the small monetary-driven component of price growth. The main source of inflation, though, is the supply side.

Yet prospects for the budget are good. Income was running above projections in January, due to extra tax receipts brought by strong profits, while forthcoming efforts to improve tax administration should also strengthen state income.