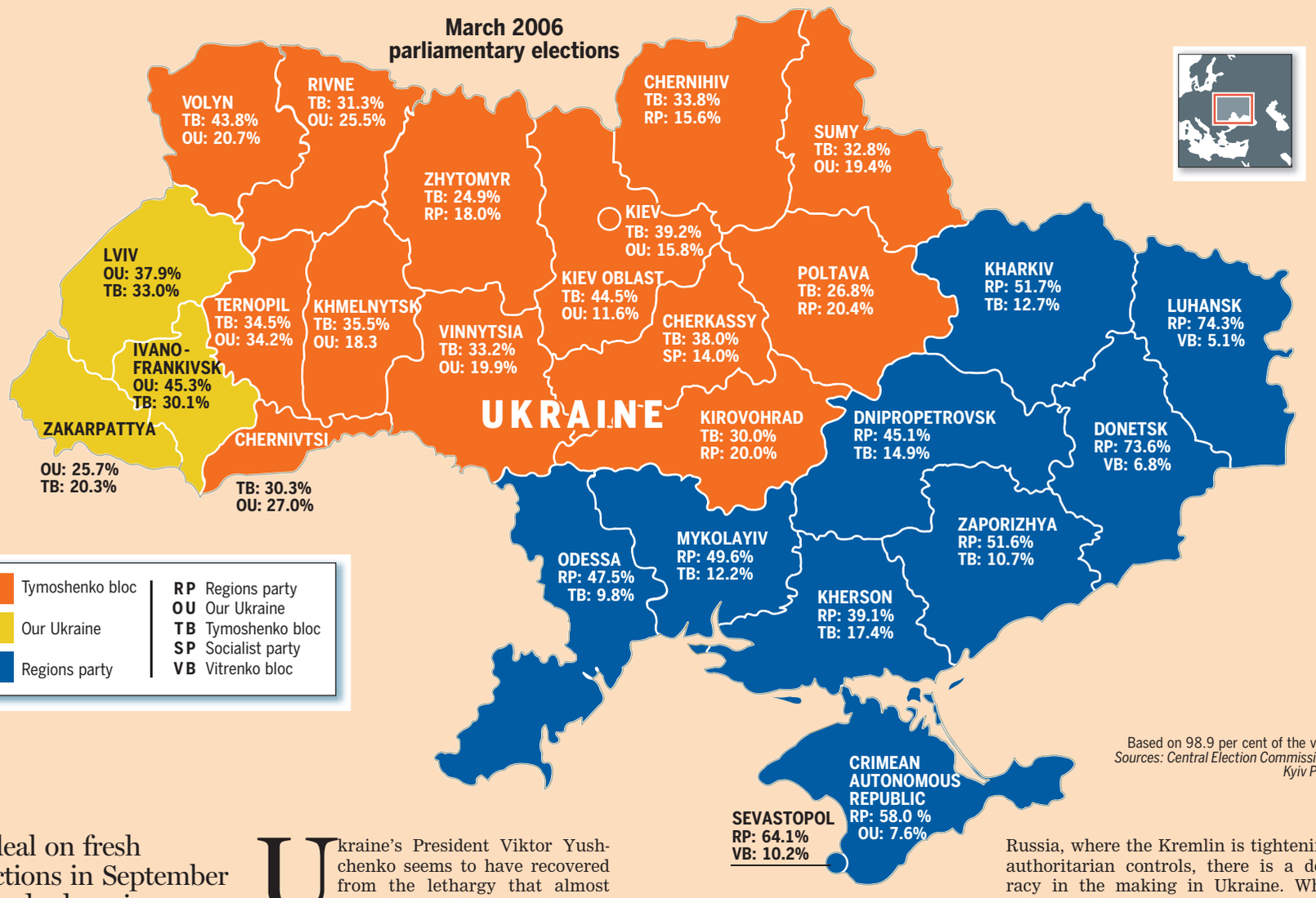
Their Ukraine

In prospect is a three-sided fight for power



Based on 98.9 per cent of the vote
Sources: Central Election Commission; Kyiv Post

A deal on fresh elections in September solved a looming conflict but will not reconcile the cultural and geopolitical divisions that caused it in the first place, write **Stefan Wagstyl** and **Roman Olearchyk**

Ukraine's President Viktor Yushchenko seems to have recovered from the lethargy that almost overwhelmed him after his triumph in the Orange Revolution. Perhaps the after-effects of his poisoning in 2004 are wearing off. Perhaps he has summoned new reserves of energy. Perhaps he has been inspired by the country's turmoil.

Whatever the reason, Mr Yushchenko is back in action. The immediate result has been a sharpening of his conflict with his Orange Revolution rival, Viktor Yanukovich, the prime minister. Last month, in Ukraine's most serious political incident since the 2004 uprising, doors and windows were smashed when Mr Yanukovich's supporters, backed by riot police, stormed a government building occupied by pro-Yushchenko officials.

Both sides drew back from the brink and provisionally agreed to hold early parliamentary elections in September, which the president hopes will clear the air. As he told the FT in a recent interview: "It's very important to understand that the political forces that then will come to the new parliament . . . even if the [same parties] come back again . . . will be different. I think they will attach more importance to political dialogue from now on."

But there is considerable doubt in Kiev whether a reinvigorated president or early elections can quickly resolve the country's political problems, which are rooted in Ukraine's regional divides, its difficult post-communist transformation and its proximity to its huge neighbour, the resurgent Russia.

The current crisis dates back to 2005, when the pro-western Mr Yushchenko failed to take full advantage of his Orange Revolution triumph or prevent destructive rows between his supporters and those of his then ally, Yulia Tymoshenko.

Under the compromise outcome to the Orange Revolution, the president was obliged to transfer power to parliament in early 2006 and hold parliamentary polls. To Mr Yushchenko's shock, Mr Yanukovich bounced back to power at the head of his Regions party and became prime minister.

Their co-habitation has been an unruly failure. At first, Mr Yushchenko gave ground, hoping to secure an accommodation with Mr Yanukovich. But – charges Mr Yushchenko – the Regions party concentrated on expanding its parliamentary power principally by bribing other MPs to change sides. In April, the president dissolved parliament and called early elections. Accused of acting illegally, he has struggled to enforce his decision: although Mr Yanukovich reluctantly agreed to the new elections, there is resistance from his parliamentary allies and it is still not clear whether the vote will take place, as planned, on September 30.

It is even less clear what will happen afterwards. Three big groupings will, as now, dominate parliament – Mr Yushchenko's Our Ukraine, Mr Yanukovich's Regions and Ms Tymoshenko's bloc. Mr Yushchenko and Mr Yanukovich broadly agree on business-oriented economic policies, in contrast to Ms Tymoshenko, who has campaigned on a platform of curbing oligarchs – despite questions about her own wealth. On promoting democracy, Mr Yushchenko and Ms Tymoshenko stand much closer. Mr Yanukovich, despite recent attempts at a makeover, still behaves like a Soviet-era party boss.

Many analysts expect the post-election negotiations to last for weeks if not months, raising questions about the government's capacity to make decisions over this time. However, the risk of violence, which seemed a real possibility during the events of last month, is now discounted, given the lack of public interest in what is largely seen as a struggle within a faction-ridden political elite.

The outcome of any coalition talks will depend as much on the distribution of power and influence as on political principles. Corruption will not go away. Business people favour a Yushchenko-Yanukovich coalition or a Yushchenko-Yanukovich-Tymoshenko grand alliance. But whether these rivals can co-operate more successfully than in the past is a moot point. So is the question of how they will tackle Ukraine's fundamental political challenges.

'Ukraine is going in the right direction but taking the wrong steps. Russia is going in the wrong direction but taking the right steps'

The country is halfway along the road from Soviet totalitarianism to full democracy. It remains divided between a pro-Yushchenko western region that fears Russia and wants rapid integration with the European Union and Mr Yanukovich's base in the industrial east, which if not pro-Russian treats the former imperial power with more deference. Politics is dominated by business groups ready to bribe officials and parliamentary deputies alike. Such groups are increasingly interested in the access to global markets that comes through EU integration and support recent moves to join the World Trade Organisation. But, for some Ukrainian industrialists, Russia's booming markets remain a priority.

The Orange Revolution supporters' hopes that the events of 2004 would mark a break with the past have been dashed. The public is thoroughly disenchanted with politics. Fortunately, a strong economy is generating jobs and boosting incomes, allowing Ukrainians to focus on economic rather than political priorities.

Yet the gains of the Orange Revolution have not been lost. There is a free press and there is real – if often corrupt and brutal – competition for power. Unlike in Russia, where the Kremlin is tightening its authoritarian controls, there is a democracy in the making in Ukraine. What it lacks are democratic institutions, notably effective courts. As Vadym Karasiov, a liberal political commentator, says: "Ukraine is going in the right direction but taking the wrong steps. Russia is going in the wrong direction but taking the right steps."

Ukraine might go faster "in the right direction" if it were not for its geopolitical position. Even in the 1990s, when Russia was weak, it was hard for Kiev to break free of Moscow's orbit. Today, with Russia increasingly willing to reassert itself in the former Soviet Union, it remains difficult despite most Ukrainians' preference for joining the EU (even though that is a remote possibility).

The Kremlin mishandled the 2004 presidential polls when it failed to secure the election of Mr Yanukovich and block the rise of Mr Yushchenko. But it continues to play politics, supporting pro-Russian parties and non-government organisations, notably in Crimea, where ethnic Russians predominate and where the Russian Black Sea fleet is based in the Ukrainian port of Sevastopol.

Valentyn Nalyvaichenko, the acting head of Ukraine's security services, warns of the dangers of Russian interference, saying: "We are a young country. For any country it is dangerous when domestic politics is being interfered with by foreign sources."

Russian President Vladimir Putin insists that he wants good relations with Kiev but he rarely misses an opportunity to fire off an insult, recently calling Ukraine "a tyranny". The Kremlin's aim is to portray the Orange Revolution as a chaotic failure – and reduce the appeal of western-style democracy in Russia and elsewhere in the former Soviet Union. For their part, Russian companies see investing in Ukraine as good business – both in non-political sectors such as retail and in the intensely politicised energy industry, where Russia's dominance as a supplier can generate political as well as commercial dividends.

The EU remains ambivalent about Ukraine. Poland and some east European member states are pressing Brussels to engage more with Kiev and perhaps offer eventual future membership. But so strong is enlargement fatigue in the Union that this is off the agenda.

Mr Yushchenko, who hoped for more just after the Orange Revolution, now accepts that the way forward is through developing economic links and securing EU aid. He knows the free trade agreement that Kiev can negotiate once WTO accession is in place will drive Ukraine to implement about half the *acquis* – the EU's membership rules.

It was hard enough for Kiev to balance east and west when there was less tension in relations between Russia and the US and EU. Now, it is more difficult. As Oleh Rybachuk, Mr Yushchenko's adviser, says: "Unfortunately for Ukraine, every time there is a conflict between the west and Russia we suffer."

To treat Japan as an economic curiosity looks ever more odd

Enough has changed since the asset bubble came and went that it is time to regard the country as just about entirely 'normal', writes **Chris Giles**

For more than a generation Japan has been a rich country with the second largest economy in the world. But it has always been treated as an exception.

In the 1970s and early 1980s other advanced economies viewed Japanese annual rates of 4.5 per cent growth with envy, since others in the Group of Seven leading industrial nations could manage little over 2 per cent. In the late 1980s, the continued Japanese expansion was greeted with startled awe and Japan's future domination of the global economy seemed assured. An asset boom gave rise to incredible calculations: the land value of the Imperial Palace grounds in central Tokyo was notionally worth more than the entire state of California.

But it did not last. The bursting of the asset price bubble in 1990 ushered in Japan's "lost decade" when property values fell by as much as 80 per cent and economic growth slid to the bottom of the G7 league as the country moved in and out of recession. Prices in general began to fall, heightening the debt burden of companies. As deflation stalked the land, Japan's economy became regarded as a basket case, with zombie companies kept alive by equally insolvent banks, staggering government inefficiencies financing roads going nowhere, crippling public debt and a looming demographic time bomb.

With such differences in performance, "except Japan" has been the watchword of economic comparisons. The "except Japan" argument has three strands: the country's economic performance is radically different from other rich countries; its culture is so weird and the concerns of its population so unique that the latest global reform ideas are inapplicable; and the political system is so opaque that reforms could not be implemented anyway.

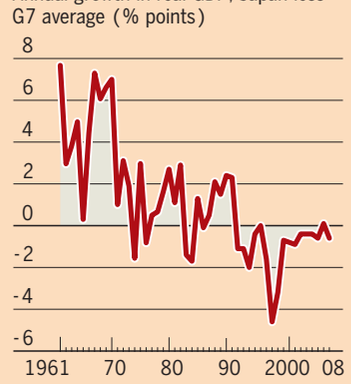
All three are increasingly wrong, according to many of the country's most forward-looking thinkers.

Fukunari Kimura, economics professor at Keio University, says the most serious misconception of Japan is that "it is not normal". He points to its steady recovery over the past five years, the longest growth spurt in Japan's postwar history, and how similar its recent trade integration with developing Asia has been to that undergone by other rich countries such as the US.

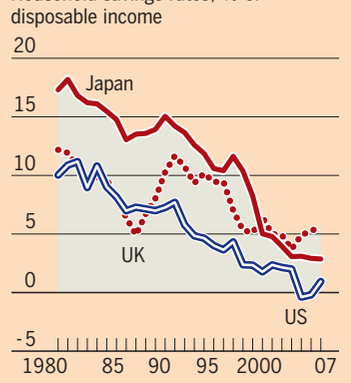
Innovation strategy is centred on opening up to foreign influences, not finding the next technological gizmo

Pointers to Japan's performance

Annual growth in real GDP, Japan less G7 average (% points)



Household savings rates, % of disposable income



2007 & 2008 = IMF forecasts

Source: Thomson Datastream

The Japanese economy is indeed much more normal now than it has been for decades. The recovery has been long by Japan's standards but not particularly vigorous. With annual real growth rates in gross domestic product of between 1.5 per cent and 2.5 per cent since 2003, Japan is now back in the middle of the G7 pack – it outpaced the eurozone and the US in the first quarter of this year. More important, the economy now seems able to grow at these steady but uninspiring rates, just like other advanced countries.

Even though interest rates at 0.5 per cent are much lower than in Europe or the US, after adjusting for inflation the real rate of interest faced by companies and households is similar – positive and low. Wage growth has also lagged behind corporate profits, just as in every other G7 country.

Household savings rates have been low and fallen in most G7 countries as consumers have taken advantage of greater access to credit, low interest rates and the expectation of continued steady growth. Japan is no different. While in 1990 its households were the misers of the world, squirreling away 15 per cent of their incomes, by 2005, the household savings rate had fallen to 3.1 per cent.

Moreover, almost every issue of public concern in today's Japan is the same as prevails in other advanced countries. Rising income and regional inequalities, the fairness of pension reforms and how to retain women (especially mothers) in the labour market are at the top of the domestic political agenda.

Fear of China's rising economic power haunts Japan as it does the US and the eurozone. As elsewhere, the concerns are misplaced, according to Chi Hung Kwan of the Nomura Institute of Capital Markets Research, who points out that Japan's exports to the US are not even in competition with those from China, since the two countries produce radically different products, something that Japan shares with the eurozone. Rather, in common with the rest of the G7, the success of Chinese low-wage sectors has benefited Japan greatly, through falling import prices, while Japanese export prices have risen.

There are are, of course, exceptions to all this normality. Japan's inflation rate is negative, although the sustained growth of the economy is expected to return it to positive territory next year. The rise in the number of elderly relative to young people is more acute than elsewhere. The country remains difficult for foreign investors, with few takeovers of Japanese entities – the cumulative stock of foreign direct investment as a share of GDP stands at 3 per cent in Japan, in comparison with 22 per cent in the US and 37 per cent in the UK.

Japan's labour market has changed radically for the young, who work on flexible contracts, but not for those who started work before the 1990s.

The weakness of the yen, too, is sometimes difficult to explain, especially given Japan's huge trade surplus. But the most convincing and verifiable cause is that Japanese households are beginning to ditch their previous unusual bias for holding all their savings domestically.

The Japanese diversification of household savings shows another weakness in the "except Japan" argument. Japan, like most other countries in the Organisation for Economic Co-operation and Development, is feeling its way towards further reform. Monetary policy is now based on an inflation target. The OECD last week showed that a series of pension reforms since 1990 has already cut the generosity of the Japanese public pension system by 15 per cent, pretty much the same as in most other large advanced economies.

Maternity and childcare rights have improved markedly, with the aim of changing companies' and women's wary attitude to childbirth. The government's innovation strategy is centred on opening Japan to foreign influences, not finding the next technological gizmo.

The speed of change will be driven by politics and slow demographic shifts. But the need for reforms and the inevitable obstacles along the way to make the economy more dynamic provide the same challenge that faces every other G7 country.

Investors are little rattled by the political strife

Trigger to an inflow of funds: Viktor Yushchenko

Political turmoil has overshadowed much of the action but investors' appetite for Ukraine's fast-growing markets is rising.

They are following pioneers such as Nestlé and Coca-Cola, which entered Ukraine in the 1990s and are making big returns. Investors tune out the political noise and focus on the economic attractions of a country of 46m, which last year registered a rise of more than 7 per cent in gross domestic product, with another 7 per cent expected for 2007.

Tomas Fiala, managing director of Dragon Capital, a Kiev investment company, says he thinks the political squabbles will be kept in check for fear of hurting business. "It is just an internal power struggle in the political elite. If the population is not reacting, not withdrawing money from the banks, and the currency is stable, then nobody pays attention."

Although growth started in 1999, it took the televised events of the Orange Revolution, which brought the reform-minded Viktor Yushchenko to power, to put Ukraine on international investors' radar screens. "Everyone is fishing around," says Jorge Zukoski, president of the American Chamber of Commerce in Kiev.

Among the first to commit itself was Mittal Steel, which paid $4.8bn (£2.4bn, €3.6bn) for Ukraine's most modern steel complex. Domestic business groups, built from sometimes murky privatisations, have meanwhile turned themselves into formidable competitors and have recently been going to international capital markets to secure global valuations for their assets and enhance their integration into the European economy. Medium-sized Ukrainian companies raised some $600m last year, mainly in London, Warsaw and Frankfurt, according to Mr Fiala.

Now businessmen are preparing larger offers, starting with Kostyantyn Zhevago, a 33-year-old billionaire, who is raising about $500m this week on the London Stock Exchange, offering 25 per cent of his Ferrexpo iron ore business. Rinat Akhmetov and Viktor Pinchuk, Ukraine's richest men, are expected to list steel, energy and media businesses by 2009.

But Ukraine still has a long way to go. Annual GDP per capita stands at about $2,275; in Poland it is $8,655. Foreign investment is a fraction of central European levels. Incomes are unevenly distributed: while top businessmen rank among the world's richest, middle-class salaries are typically below $1,000 a month and the elderly often live on less than $200, despite pension increases.

Corruption, red tape, weak courts and poor infrastructure remain problems for business people and ordinary citizens alike. Jeffrey Franks, the resident International Monetary Fund economist, says: "At some time in the future, the lack of structural reforms will take a bite out of economic growth."