

# *Truth and Beauty*

## *(... and Russian Finance)*

# Too Early to Tell

Score Card	1	Part II	16
Current Conditions - Russia	2	Russian Markets and Mayhem	16
Current Conditions - Global	3	Russia in the Capital Markets – Global Cooling	16
Politics and Other Scourges	4	Three Horsemen – Rouble, Bond and Oligarchs	17
Where did all the Money go?	7	Currencies - For a Couple of Roubles More...	19
Where did we get it Wrong?	9	How to Trade it – Picking through the Rubble	22
Through Western Eyes – Russia in the Press	10	Russia - Bearing Up/Bearing Down	23
Russia – Onwards, into the Shining Past?	15	Looking forward – Through a Glass, very Darkly	26
		Appendices	27

*During his China trip, Richard Nixon met with Chou En-Lai in the walled garden of the Forbidden City. As they walked slowly around the lily ponds, recollecting his briefing by Kissinger that Chou En-Lai was an avid student of French history, to break the ice Nixon enquired of Chou what he thought had been the impact of the French revolution on Western civilization.*

*Chou En-Lai considered the question for a moment, then turning to Nixon replied: "The impact of the French revolution on Western civilization? – it's too early to tell!"*

### **-Score Card**

- Whilst the emerging economies have of course tanked along with the G7, it is far too early to conclude that the Americano-centric economic model is eternal, or even that, after 60 years, particularly durable.
- As regards the final validation/falsification of the “decorrelation” hypothesis, again – it is simply too early to tell; the essential question is not whether the US meltdown has an almost universally deflationary effect – it does, but which countries will be first to recover – the more profligate consumption-based economies, or the formerly-thrifty goods producers.
- Our longstanding warning that “*the unsustainable would ultimately not be sustained*” was finally verified, as the grotesque US dual-deficits, credit creation, self-serving deregulation, and extravagant military spending ended the only way they could.
- Similarly, the call to avoid Russian equities due to expected turbulence in global markets has proved prescient.

- On the other hand, our hope that Russia's underlying economy could decorrelate from the global trend, and that Russia might present something of a safe-haven, was clearly over-optimistic. The contagion effect has been severe.
- While we had assumed that Russia could readily survive a number of possible shocks – credit, commodities, a dollar rebound, or a fall in global economic activity, what we had missed was that in a crisis, all correlations would go to one. Russia was hit not with one or another of these risk factors, but with a toxic cocktail of them all.
- Our bullish call on Russian debt was a mixed success: although foreign currency debt prices fell on illiquidity, they have already rebounded strongly; with no signs of credit impairment, the hard-currency debt continues to offer extraordinary value. On the other hand, in the domestic rouble debt market we are witnessing a reversion to the worst of local business practices, as issuers wonder “*why should we pay, when capital markets are closed to us?*” while the regulators look the other way.

## Current Conditions – Russia

- The Russian economy proved to be highly exposed to the unprecedented contraction in global credit conditions and the resultant collapse in commodity prices. The immediate prospects are largely a function of oil prices (which Russia may yet choose to influence by instituting a close collaboration with OPEC, and by further development of the gas cartel).
- By and large, the Central Bank and Finance Ministry have done an excellent job of damage limitation. The economic situation is difficult, but by no means as desperate as it briefly appeared in October/November, or has been portrayed in the press.
- CBR Rouble policy was initially ineffective and confused, given a mixture of national pride and the fear of panicking the populace – fortunately, this was quickly replaced by an unaccustomed degree of flexibility. The wisdom of the stepwise devaluation can be argued both ways – we would prefer a faster course – but at least the “Stalingrad defence” was abandoned.
- By contrast with some of its more democratic peers in the West, Russian policy been single-mindedly focused upon supporting the poorer segments of the population – raising wages and pensions, rather than on bailing out the owners of financial assets. Medvedev has stressed the vital importance of maintaining the >50% decline in poverty achieved over the past decade.
- To the intense frustration of the Western chattering classes, and despite the deterioration of the economic outlook, Mr. Putin remains overwhelmingly popular; tacit a torrent of disinformation in the press, what is extraordinarily is just how little unrest has actually occurred (a single demonstration – involving fewer than 1,000 disgruntled motorists/car importers in Vladivostok – has been replayed continually for nearly a month...) domestic unrest has been utterly trivial by comparison with that seen daily in Italy, Greece or France.
- From the investment standpoint, the question is not whether the situation in Russia is perilous – like elsewhere, it is; instead, investors must ask whether the market has totally overpriced the downside risk. We believe that it has.
- Russian equities are now trading at a forward looking P/E of 2.7...once again making it the world's cheapest equity market – at a fraction of the valuations of such havens of probity and stability as Indonesia, Turkey, India, Argentina, and yes, Pakistan!
- Western sentiment as regards Russia – encouraged by a tame and easily manipulated press – is as negative as anything we have seen since the end of the Yukos saga (which, b.t.w. provided the second great buying opportunity of the post-crisis period). Curiously, this seems to be especially the case for the American investment banks, which are now dependent upon the goodwill of the Washington establishment for their day-to-day survival.

## Current Conditions – Global

- Distressingly, the first phase of the US bailout appears to have been thoroughly bitched up; some \$350bn has been burned through with precious little to show for it for anyone but the intended personal beneficiaries of Mr. Paulson's largesse – while Americans are losing their homes and job at a distressing rate.  
We missed this call – having assumed that, in a true crisis situation, the US would drop the class-bias, displaying pragmatism and well-honed survival skills; unfortunately, this was to neglect the pernicious incompetence of the outgoing US administration.
- The smaller, export-dependent emerging economies are being hit hard. Mexican GDP growth is expected to be negative this year. In fact, the situation is far worse than suggested by numbers alone since, given rapid population growth, the relevant number – GDP per capita, is actually falling fast, posing a very real threat to political stability.
- Global commodities have swung from heavily overbought to grossly oversold. The declines in plantings, drilling, exploration and production, along with the drying up of Capex and the bankruptcy of the junior miners are setting up for a commodities rally at some point further down the road dwarfing anything seen in 2007-2008.
- If there was ever any doubt as to the necessity of the North Stream pipeline allowing direct export of Russian gas to Western Europe, this year's edition of the Russo-Ukrainian gas follies has laid it to rest. Since neither Russia nor Iran will allow construction of a trans-Caspian pipeline, Nabucco is destined to remain a pipe-dream; along with South Stream, the Baltic route constitutes the sole, realistic source of new and reliable gas supplies to Europe.
- Reports of the Euro's death are grossly overstated. European countries which opted out now wish that, like Slovakia, they were in the Eurozone (and are reportedly queuing up to join) – despite the lack of convergence by the "Club Med" countries, and an economic outlook at least as dire as the US, the credit-driven excesses were on average far less egregious than in the Anglo-Saxon world, and damage should thus be marginally easier to contain.
- The current crisis might have been forestalled or at least attenuated had Lehman Bros. been taken over and wound down, wiping out the equity but avoiding collateral damage. The claim that the 1998 rescue of LTCM ultimately led to the current crisis by encouraging excessive risk-taking is pernicious nonsense – the LTCM investors and stakeholders were wiped out and LTCM was wound down by its peers. Capitalist market discipline does not require collective punishment in order to be effective. Deregulation, carefully orchestrated by those who stood to reap the largest financial gains is a far more likely culprit.
- There is a fundamental conflict of interests underlying the US bailout. The sole personal loyalty of Paulson and his ilk are loyal to their economic brethren – the capitalists. They have thus refused to enforce capitalist market discipline by the simple step of destroying the equity of the institutions they were forced to salvage in an attempt to forestall the collapse of the entire financial system. The spectacle of bankrupt banks on life support continuing to pay dividends and large management bonuses is nauseating.
- Foreign investors who maintained the traditional child-like faith in the safety of US asset – Asian buyers of stakes in US investment banks, European investors with Mr. Madoff ("regulated" by the SEC), and institutions around the world that sought out the safety of AAA-rated CDOs and other structured products – are now paying the full price of their misguided trust. This will not facilitate future funding of the US deficits by foreign capital inflows.
- The safety of any asset is largely a function of the quality of regulation in the issuer country. If one invests in poorly-regulated markets, one should demand a compensatory yield to pay for the additional risk (*bearing in mind that there is nothing riskier than an AAA asset; it has no upside – either it remains stable or it is downgraded!*)

## Looking Forward: Too Early to Say

- Economic prognostication generally requires the assumption of at least some measure of continuity; asteroid strikes, plagues, and revolutions generally fog one's crystal ball. We are hearing frequent references to GDII (Great Depression II); if these extreme views are valid (and we have no means of knowing whether they are) then predictability is close to nil.
- We believe that global economic decorrelation and the continued rise of the new economies – in particular Greater China – are inevitable, although the process is apparently taking a bit longer than we had expected. In the aftermath of the crisis, we expect the BRICs to bounce first, while the G7 states remain supine for far longer.
- The first bounce is likely to occur in the commodities markets; much is made of demand-destruction, rather less of the destruction of supply. Chinese growth will certainly slow, but it is not going into reverse (*remember the constant stream of warnings of a "Chinese banking crisis" early this decade? The Chinese apparently have a talent for dodging bullets...*).
- Despite all of the clueless punditry, no one in the West truly understands China – yet therein lies the key to the global economic outlook. If China surprises to the upside, the emerging universe will outperform strongly (*if it melts, readers may wish to seriously consider emigration to another planet*).
- One thing we do understand is that Chinese demand for US sovereign debt is on the wane – Chinese accumulation of reserves is declining as the trade surplus shrinks (thanks to the vanishing US consumer), FDI slips, and domestic money leaks out. Financing the multi-trillion dollar US deficit will likely prove to be a major undertaking.
- Almost certainly, sooner or later the US will embark upon massive monetization of its debt (quaintly referred to as "quantitative easing" i.e. buying treasuries with freshly-minted dollars); ultimately, the choice will be between a deep and prolonged recession, followed by a decade of austerity and sacrifice – or simply inflating away the debt load (*take a wild guess, anyone?*).
- Deflation today – inflation tomorrow? Maybe. For now, we would look to buy spread product, in particular EMD, but be ready to hedge out treasury risk at the appropriate time. At present, global equities strike us as eminently resistible...
- We are waiting the moment to re-enter our short-USD trade against the Euro, CHF, SGD; we would take 2: 1 odds on the UK requiring IMF support by year-end.
- Russia is reliably either the world's best, or the world's worst, equity market. Having been the worst performing major index last year, barring a true global meltdown Russia will likely surprise to the upside in 2009.
- **The global economy is going biblical, as in: the first shall be last – the last first; these process, initially almost imperceptible, accelerate into an asymptote near the tipping point**

## Politics and Other Scourges

*"Owners of capital will stimulate working class to buy more and more of expensive goods, houses and technology, pushing them to take more and more expensive credits, until their debt becomes unbearable. The unpaid debt will lead to bankruptcy of banks, which will have to be nationalized, and State will have to take the road which will eventually lead to communism."*

Karl Marx, 1867

- In late 2000, we outraged several of our readers by predicting that Bush would prove to be the worst US president of the past century – perhaps of all of US history. In the event, he managed to underperform our already dire expectations; we are hard-pressed to name a single clear policy success. We wish we could have put this trade on, somewhere.

- The Chinese dragon will resume smoking – as the vendor-finance model of US consumption fails, China will feel free to assert itself far more aggressively than in the past. Not “bellicose” – “affirmative”; just look at the furious response to a few minor perceived insults by a handful of Westerners who didn’t approve of the rape of Tibet.
- When the reader encounters warnings of economic collapse and “popular uprisings” in China, he should bear in mind the dire warnings of revolt in Russia in 1998...wishful thinking, anyone? Amidst some very bearish forecasts, we note that Citigroup Hong Kong is predicting 8.2% GDP growth for the PRC in 2009.
- As both the English and the Russians learned to their expense, Afghanistan is impossible to dominate – the ultimate outcome of the American creation and support of the Taliban as a convenient means to tie down the USSR must count as one of history’s great blow-backs.
- At best, Afghanistan will require a decade to rebuild and pacify, and even this would involve a huge increase in spending on reconstruction, along with a radical change in tactics – neither of which now seem likely. As Pakistan spirals out of the US orbit, for geographical reasons Russia becomes a key NATO ally – whose favours may well need to be courted by a reversal of aggressive NATO policy in her own backyard.
- Iraq is likely to come back into the fore later on in the year; Iran is going nuclear, and all the sabre-waving in the world will not change that fact.
- Rather than wading into a discussion of the morality of the Israeli actions in Gaza, we would simply consider the likely consequences – the Western media no longer controls the news agenda; as Al Jazeera currently broadcasts 24-hour footage of mutilated Palestinian children and their distraught parents to tens of millions of Moslem homes the world over, moderate Islamic countries (Malaysia, Indonesia, Jordan, Egypt) are becoming radicalized, while in the more radical ones, Al Qaeda recruiting sergeants are looking forward to a busy season.
- Readers outside of the United States – where it was censored by the Cheney administration due to its unfavourable coverage of the Iraq War<sup>1</sup> (unlike Russia where Russia-critical media including Al Jazeera, BBC and Fox News are readily available on cable), are urged to tune in to Al Jazeera – if only to see what much of the rest of the world sees; US readers can find it on the web: [www.aljazeera.com](http://www.aljazeera.com)
- Nuclear-armed Pakistan is largely out of control – a deadly accident going somewhere to happen. President Zardari, hopelessly corrupt and with a long history of uncontrolled violence (including the shooting of at least one former wife) is widely suspected of being responsible for the death of another – no less than Benazir Bhutto. The economy has imploded, with the government paying the bills thanks only to IMF loans. With Musharaff gone, neither the Pakistani government nor the US has any effective means of controlling the army or the ISI, the rogue intelligence agency – relations with India could be better...
- In brief, 2009 is likely to mark a second year of accelerating change – boredom is unlikely to be a major concern.

### And, in the long Run... (we’ll all be Keynesians!)

- Perhaps we can now supplement our fundamental thesis – “*what is unsustainable will ultimately not be sustained*” with a second: “*what is inevitable will ultimately eventuate*”. The monopolar world centred about the North Atlantic and its preponderant power, the United States, is an extreme historical exception, a post-WW II phenomenon very unlikely to be sustained over the longer term. Ironically, it was the collapse of the failed Marxist ideology and the global spread of **some variant upon market-based economics** that has driven the secular rise of the “Emerging Nations” – the fundamental socio-economic theme of the 21st Century.

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<sup>1</sup> [http://www.nytimes.com/2009/01/12/business/media/12jazeera.html?\\_r=1&scp=1&sq=Al%20Jazeera&st=cse](http://www.nytimes.com/2009/01/12/business/media/12jazeera.html?_r=1&scp=1&sq=Al%20Jazeera&st=cse)

## A Rant: The Greatest Business Book Ever Written: Le Petit Prince

*Watching the highly sophisticated, diligent and analytical global asset allocation industry taken down by a \$50bn Ponzi scheme, the carefully crafted structure of which would have taxed the investigative abilities of a dull 12-year old, we default (if that be the term) back to the St. Exupery's wonderful children's novel, Le Petit Prince (download in English, French or Russian from <http://korczak.com/Exupery/englisch/0.html>).*

As cynical as T&B becomes, apparently we are never quite cynical enough; we know personally a number of asset allocators/FoFs who were taken in by the Madoff pyramid scheme; none of them has yet offered us a coherent explanation of how he could have done anything quite so egregiously stupid. This was not a sophisticated fraud – an Enron or a Parmalat, with hugely complex trading strategies and fraudulent paper trails requiring months of hard forensic accounting to unravel. Madoff apparently did need to bother with off-shores, complex strategies or sophisticated deceptions – this was Pet Detective stuff.

Madoff purported to be running something like \$50bn in his spare time, from his own office. No trading floors, no quants, no prime brokers, apparently no traders (indeed, no damned trading!) According to Bloomberg, the options strategy he purported to employ would have required something like 10 times the total turnover of US OTC equity options. Surely someone would have noticed the volumes. Your Grandma should have seen through this one. Perhaps she did...if so, perhaps she can now tell us who or what is going to replace the billions in hedge fund liquidity which is about to disappear – after the bank prop desks, off-balance sheet vehicles, etc. the lifeblood of our beloved financial ~~casino~~ ~~casino~~ industry is drying up. *Self-regulated markets*, indeed!

Like much of the financial community, the fund-of-funds industry is peopled primarily by hard-working drones, their skills honed by fierce competition with other drones, none of whom pause to question the basic tenants of what they learned in business school. Running the Nikitsky Fund, T&B himself struggled for several years fielding questions along the lines of *“how much of your performance was due to our 4 largest positions last Wednesday”* – before finally growing bored with the game (not to mention

terrified of the markets), choosing to return our investors their money – parting as friends (and thus, missing out on the current carnage: **Smart is good, but lucky is better!**)

In St. Exupery's story, Le Petit Prince tells of his travels across the night sky, introducing us to planets peopled by odd folk – worlds of self-important bean-counters, terribly convinced of their own seriousness and the significance of their trivial occupations; of planets with important men constantly in a hurry, bent over interminable tasks of utter meaninglessness – a good introduction to our own planet where a searchable résumé and a good business suit are an acceptable substitute for the willingness to question convention and a lucid thought process.

These are not new phenomena nor are they confined to the world of business – they are as old as mankind. Think of La Bayadère, that wonderful oriental fantasy of high-priests, mumbling incantations and tossing incense into the pyres of the Fire God, accompanied by elaborate and supremely important ritual – or of medieval astrologers muttering in bad Latin as they read the future in the paths of the stars, alchemists reciting hugely complex incantations as they purport to purify base metals into gold.

Confronted with the raw chaos of existence, men instinctively seek to create systems providing desperately needed certainty and comfort. These systems tend to become in equal measures futile and eminently silly – the reading the future in the entrails of sacrificial chickens no more so than the ritualized due-diligence operations of the asset allocators.

### Neo-Liberal Capitalism – Another God that Failed

Like Marxism before it, the Capitalist system in its **most extreme version** has failed quite spectacularly. The blind stupidity, self-serving greed, and ultimately, the willingness to ignore the basic laws of physics by its radical proponents – the self-satisfied denizens of Wall Street and Washington – has needlessly discredited the fundamental notion of a market-based system which, for all its glaring inefficiencies and injustices, has proved, at least in its more moderate formulations, the

most successful basis for economic regulation yet devised.

The problem arose from the fact that, like all man's other non-theological constructs, market-based capitalism had no legitimate claim to be all-potent, all-seeing, or superhuman in its scope. Those who claimed some sort of Hegelian finality for what was ultimately nothing more than one particular mode of economic organization, seeking to elevate the free market system into a sort of demi-god, have caused more damage to the Capitalist ethic than all the paleo-Marxists could dreamed of.

Ironically, many of the justifications for the failure of the ultra-liberal system are reminiscent of nothing so much as of elderly Marxists explaining how Marxism never failed – it was, so goes the claim, only the Soviet Union that failed to properly apply the supposedly-infallible Socialist doctrine. Similar claims that the US system failed because of excessive regulation – in the midst of the greatest orgy of deregulation since the Mongol invasions – are laughable.

The FT's Martin Wolfe wrote an excellent column on this matter – please see appendix 5. Those with enough patience may wish to default back to Karl Popper, and his analysis of "falsifiability".

### **Where did all the Money go?**

The fundamental problem facing the global economy is that an enormous amount of paper wealth was conjured up, ex nihilo, over the past decade. Like a series of fractals, this extended throughout the economy, as the attitude towards wealth-creation assumed a wildly optimistic cast and Everyman acquired the notion that divine providence had intended for him personally to become rich. In the meantime, governments suddenly came to the realization that one could spend trillions on military adventures while cutting taxes thanks to ever-increasing economic growth; investors could earn risk-free returns several times the underlying growth rate by the simple expedient of increasing the share of GDP extracted as profits; hedge funds could net colossal sums by arbitraging out tiny market inefficiencies; while bank prop desks made billions based upon their informational advantage.

Delusional thinking became contagious – as corporate chieftains earned a thousand times the average (shrinking) salaries of their

employees, justified by their somewhat-hypothetical "leadership qualities." these same employees availed themselves of the opportunity to maintain their two-SUV lifestyles – on credit. It was a brave new world indeed<sup>2</sup> as "faith-based economics" prevailed.

Needless to say, the music eventually had to stop. In the short-run, whether the global economy can halt its slide off of the cliff-face will be largely a function of the success of the enormous fiscal support package with which Mr. Obama plans to launch his presidency: a trillion per annum (not counting the TARP)...more?...much more?

Will the US Congress pass it? Dilute it? Hesitate until its too late? Break down into partisan fighting as the Republicans prove psychologically incapable of acknowledging the failure of their supposedly infallible model? And what of the health-care costs for the 2M employees/retirees/ dependents from the automobile industry? The coming wave of retiring baby boomers? The rapid secular rise in personal savings, going into the worst downturn since 1929? Perhaps it is best that some unknowns remain unknown...there is more than enough to be distressed about in the very short term.

Desperate measures are clearly called for. While their first- and second-order consequences for the dollar and the global financial system are numbered amongst the "known unknowns," given that the consequences of doing nothing would be classed as "known knowns" – and are known to be not-pretty – there is no real choice. Another jolt of the defibrillator? What have you got to lose?

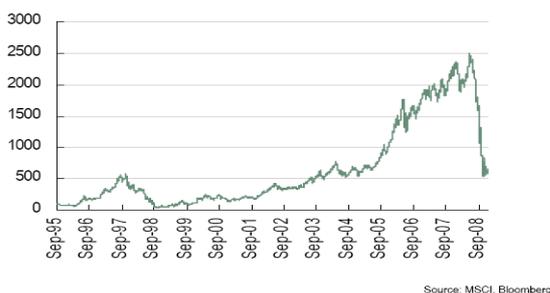
With a US administration coming to power at the end of a period of self-dealing and economic mismanagement we would frankly never have dared imagine: the continued use of public funds to support the banking system without proper accountability or transfer of ownership; the failure to address the collapse in the mortgage market; as well as refusal to abandon failed economic buzz-phrases – our crystal ball is frankly clouded; we are dealing with more uncertainty that encountered at any time in our generation.

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<sup>2</sup> *In the famous words of Aldous Huxley, the problem with Californians is that they think that death is optional...*

## Ritual Bloodlettings – the Slaughter of the Analysts

We are now witnessing the mass failure of a range of financial professions: investment bankers, rating agencies<sup>3</sup>, regulators...and prominently among them, analysts and strategists of all stripes. An e-mail has been circulating in Moscow giving the January 2008 year-end predictions for the RTS index by a score of influential Russia analysts<sup>4</sup>. The range – from about 2100-3000 – has proved a bit over-optimistic...by say 75%!



Déjà vu? Honey, I think this is where we came in...

Fortunately, we Russia market strategists were not alone; oil analysts, whose guestimates had comically lagged crude prices every year for a decade, finally decided to get ahead of the curve, ramping their predictions up to a couple of hundred dollars a barrel – just before prices crashed. Having very recently warned of oil prices at \$200, Goldman's is now warning about oil at...\$45. Not to be outdone, DB has just come up with a somewhat whacky call that the consensus forecast would hit \$10 (the futures curve suggests a more rational medium term target of \$80/bbl).

<sup>3</sup> Our prediction that the rating agencies would face a wave of lawsuits and perhaps criminal liability for outright corruption (sale of investment grade ratings for the CDOs) – a criminal conspiracy largely responsible for the American meltdown and the destruction of the global financial system, have thus far gone unfulfilled. The logic of condemning minor fraudsters to terms of life-imprisonment, then allowing those who cause infinitely greater damage by violating a much higher standard of trust to go unpunished, evades us.

<sup>4</sup> Mercifully, T&B fails to appear, but only because we fobbed of the journalist's questions by saying that it was like trying to estimate a phone number.

Similarly, predictions regarding US corporate earnings have proved something of a bad joke. Goldman's totally absurd Abbey Joseph Cohen has finally been put out to pasture; amazingly, the rating agencies have escaped prosecution for their conspiracy to peddle corrupt investment grade ratings on complex debt securities; Dow 100,000 has been conveniently shelved while everyone is praying for a decent trading rally to sell into, before crawling up into the "safety" of treasuries. With the possible exception of Merrill's David Rosenberg, no mainstream analyst had predicted anything like the current economic havoc<sup>5</sup> - and with due respects, not even Rosy knows what the world will look like when we finally see the bottom.

## Predictions are Risky

*- Especially those involving the Future...*

Predicting discontinuities can be a risky business. Indeed, in 2004 T&B predicted an imminent debacle caused by the violent unwind of the global imbalances and a sudden end to the "rolling bubbles" which had

caused a succession of diverse asset classes to become wildly overvalued.

Obviously, our call was mistimed: in its infinite (short-term) wisdom, the US Fed, in cahoots with the politically hedonistic Bush clique, managed to pump sufficient

liquidity into a moribund economy to make the dead walk.

Alas, three years later and we encountered our predicted crash in all its terrible glory. Perhaps, had the monetary authorities allowed a recession earlier in the decade, it would have been of the garden variety – uncomfortable but short-lived. Instead, we are now faced with an unknown but finite probability of something along the lines of the Great Depression... frankly, neither T&B nor anyone else we speak to have any real assurance on how this one plays out.

<sup>5</sup> Even T&B was too optimistic and we were hard-line US-bears. Of the non-mainstream analysts whose work we read, only Marc Faber and Simon Hunt enjoyed a sufficiently catastrophic outlook

As for the macros, with the USD repatriation trade drying up, we are waiting for the end to the current correction of the New Year's rally to reinstate our long-standing dollar-devaluation/dollar-crisis call – which we had temporarily stepped back from in mid-year 2008, purely on a trading basis. We continue to expect a precipitous drop in the erstwhile global reserve currency, with the potential for severe disruption of the global trading system.

Whilst the obvious question is “*sell the dollar against what?*” (given that currency trading is now a beauty contest involving a bevy of particularly ugly women) we continue to believe that the Euro will come through rather better than expected.

ECB policy was strongly contracyclical, bank lending was less egregious, while domestic savings rates were far higher. Although the PIIGS-problem (Portugal, Italy, Ireland, Greece, and Spain) is meaningful and the expected economic convergence has stalled, the “Southern Rim” countries – now faced with downgrade – account for only a small fraction of total European GDP, and vitally, have been unable to influence ECB policy.

More to the point, the Eastern European and Scandinavian countries (not to mention the UK!) which remained outside of the Euro were hit far harder, with several now clambering to get in. Whilst debt spreads between Germany/France and the weaker members are widening, we believe that the gleeful predictions of a collapse in the Euro will once again prove to be wishful thinking.

Thus, the transition from a single global reserve currency based upon the US Dollar to a multipolar system is arguably the great challenge for the global economy over the next few years.

## **Where did we get it Wrong? (And Ultimately, How Wrong did we get it?)**

### **-Globalization – Getting Ahead of Ourselves**

*Whilst T&B has long been on the record for predicting a wrenching end to the global imbalances characterized by the US twin deficits – repeating the refrain that “what is unsustainable will ultimately not be sustained” and warning of weakness in all equity markets, we failed to foresee the full impact of global mayhem upon the underlying Russian economy.*

*With the global economic context both threatening and extremely difficult to read, it is clear that near-term Russian economic performance will be largely conditioned by a variety of global factors.*

One of the essential points about the current crisis – still missed by most commentators – was its simple inevitability. The US could not sustainably remain the sole source of global demand growth, producing less and less, while paying for valuable Asian goods and global mineral resources with fiat currency; this was the economic equivalent to designating 10 sq. km of the Pacific as Demand-land, and simply dumping consumer goods into the ocean. The question was not if this model would collapse, but when.

On the other hand, T&B had expected that, since the worst excesses (notably, the twin deficits) were of American origin (and the excess-savings countries could ramp up domestic demand as required) the crisis would be at least partially confined to the US and mirror economies, e.g. the UK. In the event, the collapse in US demand and global credit availability has had massively deflationary effects everywhere, with Russia suffering the combined effects of a sudden withdrawal of liquidity and a collapse in commodity prices well beyond anything rationally predicted based upon the rapid Asian growth of the previous decade. While we continue to believe that the “decorrelation” thesis will eventually be vindicated in the post-crisis phase, for now, it is a definitely out of fashion.

Those still holding to the Americano-centric consensus view (the same folk who, a year ago, laughed off even the possibility of a US economic implosion) are trumpeting this “reкорrelation” as proof that nothing ever changes – assuring us that American global

economic predominance is eternal. Whilst the US economy remains the world's largest, many of the arguments trotted out to demonstrate its overwhelming weight are fallacious – based upon comparisons of nominal GDP weightings of the G7 versus the emerging countries, and especially, given that the GDP numbers for some of the former (e.g. the US/UK) are overwhelmingly based upon consumption rather than production. It should be intuitively obvious that the propensity to consume has never been a sustainable basis for economic strength.

Outside of theology, precious little is eternal – although admittedly, tectonic shifts in the economic centre of gravity occur rather more slowly than T&B had expected. It is a safe bet that, by the end of the current recession/depression, the relative weightings of the United States (and more generally, the G7) economies will have been sharply curtailed; although the full impact of this shift may be of greater relevance for the next recession.

That said, we expect the outcome of the present economic cycle to be determined not by events in London or New York, but by the impact of decisions made in Beijing. While China, the only potential major source of incremental global demand is slowing substantially, we are seeing contradictory information about the actual magnitude of the slowdown (with GDP projections ranging from 2% to 8.5%...)

Although the challenge of creating a new and more balanced economic model virtually *ex-nihilo* in a country of 1.3bn should not be underestimated, “authoritarian governments” have a great deal more latitude in reacting rapidly and purposefully to events – especially in times of economic turmoil<sup>6</sup>.

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<sup>6</sup> For now, it will be interesting to watch the evolution of Chinese military/diplomatic policy as the relative importance of its relationship with the US declines given the failure of the vendor finance model. Pity the Tibetans – the Taiwanese will accommodate.

## Through Western Eyes – Russia in the Press

### Who Else Gets it Wrong?

*Readers regularly enquire as to why we still bother to beat up on the Western press. Do we imagine that somehow we can shame the editorialists into belatedly developing some sense of decency? Are we mad? Anyway, what does it matter? They will continue to serve their political masters, unwittingly for the dimmest, consciously for the most cynical – but after a decade of disinformation, who in Russia cares much anymore?*

*Russians wisely view their own propaganda no less sceptically than that of the West, whilst economic opening and integration have proved to be a distinctly mixed blessing – the foreign money is out, WTO a hostage to politics, so let their hired hands rant; what earthly difference does it make?*

*Alongside our taste for whipping dead horses (the live ones we treat with the greatest of kindness) there is reason for our persistence.*

*What we have warned of for years is coming to pass: the Russians – excepting a tiny Western-leaning sliver of the population – have concluded that the Western opinion is deeply anti-Russian, hypocritical and frankly dishonest. After years of tendentious, unfair coverage – terrorist outrages in Russia are somehow justifiable; the right of the Ukrainians to steal gas is taken for granted; Russia's actions in her “near abroad” are interpreted solely from the standpoint of America's geopolitical interests – it was perhaps the Western media's outrageous coverage of the Georgian War which brought matters to a breaking point<sup>7</sup>.*

*The issue is not the patent dishonesty, to which we have become accustomed, but rather how totally counterproductive it has all been: it was something far worse than a crime, it was a mistake! Thus, the sole real mystery is what, precisely, did those who organized these propaganda campaigns hope to achieve? Did they imagine they could replace an overwhelmingly popular Putin with the servile and stupid Nemtsov? Was Russia going to capitulate before a stream of invective, setting its priorities in a fashion*

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<sup>7</sup> Even the BBC, most responsible for that disinformation, has belatedly admitted that it was manipulated by the Georgian side which invaded a *de facto* independent territory with reckless disregard for civilian lives. See Appendices 1-3

agreeable to Washington because the Washington Post called them “Stalinists?” Did the Russians not know in whose interests Khodorkovsky and his ilk ultimately worked? Were they expected to desire a return to the disastrous Yeltsin years – or to spend the new century apologizing for the abuses of the USSR?

The propaganda war was not solely a Neocon phenomenon – it enjoyed broad support throughout the Fifth Estate. The result has been what would have been expected: irate with the constant stream of invective, and not lacking in some measure of paranoia, Russia increasingly views the West, and in particular the United States, as a sly, mendacious adversary. The ability of the Atlantic countries to influence events within Russia in any positive direction – very substantial in the 1990s – was reduced to nought years ago.

There is no new Cold War, nor is there likely to be one; given the current economic situation, neither Russia nor the West can

afford to open up any new battlefronts. Yet a historic opportunity for a convergence of interests has been missed – with the servile and manipulated Western press shouldering a large measure of the guilt.

Thus, there follows a long rant – those of our readers who find the press above

criticism, or, to the contrary, have long since abandoned hope, may wish to skip to page 16.

## Lies, Damned Lies, and the Financial Times

### More Wishful thinking

The Financial Times – once upon a time a thoroughly decent source on Russia (when the sceptical but deeply benevolent Robert Cottrell ran the Moscow Bureau, and again, years later, when Neil Buckley, a hard-working newsman without any particular agenda, briefly ran the show) – is now competing with The Economist for outright disinformation and Soviet-style manipulation.

The FT website (Dec 27) led with a most alarming headline “Russia Braced For Unrest”. Worried, T&B clicked through to the article and – surprisingly even by the dubious standards of the FT’s Russia reporting – there was literally nothing to substantiate any meaningful risk of even the most moderate social disruption!

The article states (correctly) that Russia has devalued the rouble by a further 1%, suggests (credibly) that they may devalue by a further 10%, and then notes that the Vladivostok police broke up a demonstration against an increase in used car import tariffs (*presumably by the importers: ed.*)...several weeks before.

Meanwhile, Greece is burning, Italian cities are regularly paralyzed by massive demonstrations, France suffers repeated bouts of severe urban violence (with 1100 cars burned on New Year’s Eve alone), yet apparently none of them is threatened with a forceable overthrow of the government – while for Russia, yes, there was a protest about used cars!

This is a thin reed indeed, so the article continues with a snide quote from Mikhail Kasyanov (a former Prime Minister, known as “Misha 2%” for his egregious corruption), another from Gorbachev – not otherwise renowned as an economist (he was apparently most worried about “moral bankruptcy”) and

finally, Boris Grizlov who typically blamed “the opposition” for that car demonstration (as if used-car salesmen could not organize a demonstration on their own). A month has gone by, and amazingly, anyone perusing the David Johnson List is still reading about that same demonstration

### “Growing Unrest” – Insomniacs, All!

Not to be outdone, in a recent piece the WSJ warns of “growing unrest” in Russia. We learn that several thousand pensioners in a small provincial city marched to demand the reinstatement of their discounts on public transport (these were initially monetized by the government – which quickly backed down, allowing them to choose between cash or

#### Finally, an Outstanding Western Source on Russia.

For years, we have been fielding questions from readers anxious for more information about Russia. The Western press is pretty hopeless – generally at the service of the powers that be, is positive on Russia solely when it is acting in the perceived interests of the dominant Western powers – their mishandling of the Georgia-Ossetia debacle was a case to point.

Our old friends provide a far more scholarly assessment of the press bias and disinformation than T&B could hope to. Interested readers should sign up for their mailing list. In particular, Professor Hahn’s work is outstanding.

<http://www.russiaotherpointsofview.com/>

keeping their discount) while Vladivostok saw a protest against tariffs on used car imports (yes, the same one... ).

Not to be outdone, Bloomberg News seems intent upon creating a sense of catastrophe. Indeed, their coverage of Russia has deteriorated from the tendentious to the downright silly – they recently headlined a Russian “crime wave” in Top News, this after three separate incidents of armed robbery in Moscow – a city of some 17M inhabitants!

The Economist has been enjoying the culpable pleasures of *Shadensfreude*, suggesting that its bearishness about Russia has been borne out by the crashing markets. This begs the question “and what about the rest of the world?” Stopped clocks get it right twice a day; apparently, the fact that the Balts, whom The Economist praised to no end, are now heading to the IMF for bailouts, while the US-led economic miracle for which they cheer-led so enthusiastically proved a mirage, does not warrant a corresponding *mea culpa*.

## FT - Propaganda 101

The trademark FT style of Russia reporting was introduced by their former bureau chief, the skilful but devious and intellectually dishonest Arkady Ostrovsky: take a simple event – anything from a heavy-handed police raid to an old lady being mugged on the Metro (literally) will do – report the facts accurately, then build an entirely fantastical super-structure on top of the event, e.g. show how said mugging proves that no one is safe while the Secret Police set out to restore the USSR.

One of our American readers forwarded us one of the most recent: <http://www.ft.com/cms/s/0/e5cdef46-d374-11dd-989e-000077b07658.html>, reporting a police search of the computer system at the St. Petersburg office of the longstanding dissident organization Memorial. Since it happened in Russia, it was automatically adjudged front-page news.

*The paper is worthy of analysis, primarily as an illustration of how the press works. First, read the article and ask “what actually happened?” (as often as not the answer will be: “in fact, not very much”).*

The St. Petersburg police carried out a typically heavy-handed Russian search, checking the computer system of a feisty NGO, Memorial, which has periodically suffered minor harassment over the past decade. They arrested no one, did not close

the office, nor did they confiscate any hardware or files. At the end of the day, they found nothing, and no charges were filed or threatened. When the cops left, Memorial understandably telephoned their journalist friends for a chat. The FT, delighted for any scrap of news to substantiate their standard narrative - *The USSR is Back!* – jumped on it.

Our best guess would be that some local cops thought Memorial unpatriotic, and decided to have a closer look: hopefully, there would be something juicy in the files – money from foreign governments, plans for political actions, contacts with dodgy individuals. A second possibility – somewhat less likely we think – is that they were indeed interested in the historical aspect: had Memorial uncovered anything new and explosive regarding the Stalin years, or was it just the usual and well-documented litany of abuse and tragic human suffering, abundantly documented and widely discussed since the late 1980s?

None of this is meant to justify the search - the police should not be engaged in fishing expeditions, especially as regards non-violent human rights organizations. The point is that it was a fairly trivial incident of the sort which has occurred regularly in Russia since the mid-1990s, and indeed, surveillance of dissidents under the excuse of fighting terrorism (or money laundering, or whatever) is not unknown in other countries, not all of which would be classed as “emerging”.

Consider for a moment the growing police state which, justified by “promoting public safety” has been instituted in the UK with hardly a peep of protest: in London alone, there are some 1.5m surveillance cameras filming everyone and everything; computerised DNA data bases now encompass a growing share of the population, including people accused of traffic violations; systematic electronic surveillance of private individuals is taken for granted; and amazingly, the police can impose restraining orders on citizens without judicial oversight or right of appeal.

Apparently, none of this is outside of the range of behaviours acceptable by countries of which the FT presumably approves. We invite the reader to imagine what the FT will headline the day that Russia sets up an “anti-terrorist” DNA data bank!

## The End of the Illusions – The Georgian War

A fundamental turning point in Russian perception of the motives and probity of Western media and governments was reached with the transparently biased reporting on the Georgian war, presented as an unprovoked Russian aggression against a sovereign state – until, that is, the former United Nations representative of said State admitted what had been patently obvious from the start: that it was provoked by the Georgian invasion of South Ossetia, carried out with reckless disregard for human life.

To its credit, the BBC was the first major Western medium to debunk the official Georgian line – but this several months after the fighting ended. Their report (attached as appendix I) levelled serious and well-substantiated accusations of war-crimes against the psychopathic Saakashvili. Over the following weeks, numerous other Western sources reluctantly joined suit (a paper from the New York Times is found in Appendix II, followed by an incisive analysis of times reporting by Mark Ames, in *The Nation*, Appendix III).

While the half-hearted retractions are to the BBC's credit, what is unfortunate is that they allowed themselves to be egregiously manipulated, signally failing to spot the obvious, at a time when it still mattered – i.e. as McCain and Cheney were drumming up anti-Russian hysteria for their own political purposes.

Indeed, in many ways the propaganda operation was reminiscent of the equally fraudulent WMD dossier, put together by man of the same political operatives. While ultimately, the US press was heard bleating piteously about how they were lied to by their own government, by then Iraq had been devastated on fraudulent pretences. If the press has one overarching duty of diligence, it is to question the motives and probity of its own side. In this, they have signally failed.

## Media of Mass Destruction

We see little interest in discussing who was to blame. It has now been established beyond any reasonable doubt that Georgian president Saakashvili attempted to resolve the decade-old Ossetian question by either killing or driving the So. Ossetian population into exile in Russia, perhaps in the mistaken belief that Washington would back his coup with diplomatic or even military force

Instead, what we find most striking is that no reasonable person following the events could have been misled unless he wished to be. As we noted at the time, for the first 48 hours the BBC got it pretty much right, before doing a 180-degree turn, lapsing into outright propaganda – presumably on orders from their politically-sensitive board of directors.

The hypocrisy of certain Western governments and of their tame press was not an edifying spectacle – as Vladimir Putin put it, *the aggressors became “freedom fighters,” the victims were treated as aggressors.* Russia was expected to wink at the murder of a dozen of its peacekeepers by their own Georgian colleagues, as well as the bombardment of the civilian population of a de-facto autonomous region closely allied with them.

Georgia's claim to be simply reclaiming its own territory collides with the Kosovo-precedent of national sovereignty, and in any event, indiscriminate artillery bombardment of one's own civilian populations is not an accepted means of winning hearts and minds.

Although – like the Iraq WMD dossier before it – the truth eventually became undeniable, by the time it did the damage had been done – poll the man on the street in London or New York and their recollection of this story will be as initially misreported – indeed, Bloomberg reporters still airily refer to “Russia's invasion of Georgia” without modifiers.

As a result, a majority of Russians are firmly convinced that the liberal, caring-and-sharing win-win discourse of the West is not worth the paper it is printed on – that, like every other empire which has or will ever exist, from the Romans to the Soviets, the Atlantic Alliances seeks to use ideology as a fig leaf to advance its own sectorial interests. Thus, only a very firm stance can prevent continued Western encroachment on Russian national sovereignty. The free and fair Western press appears in the great tradition of the late and unlamented Soviet propaganda machine.

## Stalin – L'eternel retour?

The undertone of much of the coverage is, of course, that Russia is threatened with a resurgence of Stalinism – something anyone with even a passing familiarity with modern day Russia knows to be utter nonsense.

First of all, it should be intuitively obvious that in a proto-Soviet system, the Memorial office would not have been raided – for the simple reason that it would never have been allowed to open in the first place. In a similar vein, for the past eight years we have encountered constant warnings of the growing suppression of dissent – accompanied by a steady stream of invective from the self-same old dissidents who, largely ignored at home, are considered supremely important by the Western media. Either dissent has been suppressed – and the dissidents are now in prison, not speaking on Radio Echo Moscva – or it has not, and their message is misleading.

It is obvious that any new political system in Russia will to a great extent reflect Russia's historical political traditions – roughly speaking, an alternation between brief periods of anarchy followed by longer phases of strong centralization of power. The Soviet Union was an ideologically-based conglomeration of nations – a supranational empire. That empire has shattered, with its Marxist ideology as dead as the millennialist mentality that once rendered the USSR so formidable. Thus, rather than fighting the last cold war, it would make a great deal more sense to seek to avoid the next one.

Russia, not the USSR, is coming back – as a nationalistic, self-referential nation state. Whether the West likes the fact or not, there is very little that it can do to influence it – at least not in a fashion favourable to their own interests; thus, as in their dealings with a resurgent China, not “friendship” but rather, a win-win policy of accommodation and cooperation would be mutually beneficial for all sides.

## When even the Past is Unpredictable

Finally, there is the allegation that Russia is re-writing her own history – and it is unarguably true!

The essential point is that **every country re-writes its own history**. Some once – many repeatedly.

Do American school children grow up endlessly discussing the My Lai massacre? Do they learn how some 3 million Asian peasants were burned, buried under rubble, napalmed to death, the last million for the (acknowledged) purpose of allowing Nixon to save face? No, they learn that “mistakes were made and we moved on” – then they turn the page to a happier chapter.

How much do the French learn about the use of torture in Algeria? The British about Suez? About the subversion of Iran? Dutch children learn how the valiant Dutch resisted the Nazis down to the last man... a convenient myth. The Ukrainians and Poles learn of their heroic resistance – not of the savage pogroms in which their large Jewish populations were repeatedly tortured to death in orgies of violence matching anything invented by the Nazis (to whose cause the Balts, who now present themselves as history's noble victims, were deeply committed – fighting tenaciously alongside the invading German armies)

Those of our readers familiar with the histories of Latin America or Asia (in this context, Japan constitutes a veritable goldmine) can no doubt provide equally edifying examples of historical revisionism. Yes, Russia is rewriting her history – not to justify Stalinism but to providing a more “patriotic” view of her past. Let he who is without sin throw the first stone!

Civilization is a triumph of reason over man's basic drives and instincts – there is nothing noble about the savage – while purportedly benevolent political ideologies generally serve as nothing more than a fig-leaf for self-interest and the will to power. Thus, as Bismarck said of laws and sausages, it is best not to look too closely at how history is made. Every country needs its national myths, with the most successful states creating a heroic past to fuel the patriotism of the masses. How else does one persuade government officials to scorn bribes, new generations to throw themselves onto the machine gun turrets – except by the desire to equal the selfless bravery of their fathers?

## Russia – Onwards, into the Shining Past?

Russia spent much of the 1990s apologizing for her Soviet past – a vitally necessary phase to smash the intellectual foundations and mythology of Marxism, preparing the populace for the wrenching transition to a new world and forestalling the risk of a Communist Revanche. That phase has now ended, with Russia at no more risk of falling back into Communism than of falling under the influence of the Hari Krishna International.

As regards the preservation of certain symbols of the Soviet past, there are generations of elderly Russians who grew up, dreaming and sacrificing themselves for the Soviet ideal – they were neither more culpable nor more foolish than Good Americans, Germans, Poles or Japanese. Tribal animals in our DNA, man is biologically patriotic – and whether born in peaceful Copenhagen or bellicose Germany, unless forced into dissidence by circumstance or psychology, the overwhelming majority of men subscribe to the beliefs and values of their societies.

Russians aged older than 30 years in 1991 largely comprised a lost generation: the majority too old and inflexible to understand and adapt to Russia's sudden transformation into the wildest forms of bandit capitalism; a substantial majority fell by the wayside, into grinding poverty at best – alcoholism, despair, and an early grave at worst.

Mr. Putin is not there to flatter our Western sense of inherent superiority – his task is to fuse a new body politic and sense of national unity in Russia. Thus, he finds little useful purpose in rubbing the elderly noses in the failure of that in which they so fervently believed: the Soviet Mission, the Shinning Future, the International Proletariat – endlessly reminding them of how they were abused, lied to, their youths wasted in futile endeavour. They have already paid the price for being born at the wrong time in the wrong place.

Whether or not the West approves is utterly irrelevant. It is up to the Russians to determine their own political model, and if there is one point which drives the editorialists to paroxysms of frustration, it is the inescapable fact that **a sizable majority of Russians Love Putin!**

This inconvenient truth was until recently attributed to his generous provision of bread and circuses – it is now time to switch narratives. Economic hard times have signally failed to impact his personal popularity (82% favourable opinions in the last Levada polls, despite the fact that, like crisis-hit people everywhere, some 42% of Russians say their country is now going in the “wrong direction.”)

Vladimir Putin remains, in terms of popularity, head-and-shoulders above any other major political figure on the planet...and as Ezra put it – all the rest is just lit'rature.

## Part II

### Russian Markets and Mayhem

#### *-Russia in the Capital Markets – Global Cooling*

*From the Slavic standpoint, events have provided us a sharp reminder that Russia does not exist in a vacuum; any predictions as regards EMEA financial/economic performance require taking a view on global macroeconomics. Several amongst the “Great Reformers” – inter alia Latvia, Hungary, Ukraine and Georgia – would already be bankrupt were it not for IMF/EU support; absent a sharp turnaround in the global economy, at least some of them will likely go to the wall even with such support. The wonders of open capital markets have proved catastrophic for several post-Soviet states, as the European banks first flooded them with liquidity, then suddenly withdrew every last farthing, leaving the borrowers beached like so many codfish.*

*As regards Russia, CBR Forex reserves and the various government rainy-day funds are sufficient to ride out a further 18 months of global recession and extremely low oil prices without substantial policy inflexion; were the global slowdown to extend into the next decade, proactive policy adjustments, e.g. decreased government spending, a closing of the capital account and further devaluation would be required. Even in the extreme case, i.e. were the crisis in the West to worsen further, the 1998 crisis demonstrated that Russia is highly “fault-tolerant.” Given self-sufficiency in all major commodities (except perhaps Mercedes motorcars) even in the unlikely event of a new global ice-age, Russia could survive relatively comfortably on internal markets and resources alone.*

The Russian crisis has exceeded anything that could have been rationally predicted based upon internal factors alone. While it has revealed serious weaknesses in the economic montage (as well as some strong points, e.g. the ability of the CBR to move quickly and pragmatically to forestall the threatened collapse in the financial system) it was primarily an import.

During the first phases of the US financial crisis – the collapse of asset values between July 2007 and August 2008 – Russian asset prices and economic results actually held up quite strongly. The initial response of the Central Bank was fully appropriate – a

successful endeavour to push liquidity into the economy along with proactive, explicit support for the banking system which initially cushioned it from the impact of the global crisis.

Alas, the spreading meltdown is proving to be not of a garden-variety recession, but rather a systemic failure; no one seems entirely safe from the second and third phases.<sup>8</sup>

Understandably, Russian policymakers were blindsided – not even the most pessimistic of the mainstream economists predicted the catastrophic outcome of a decade of faith-based US economic policy: the collapse of the entire US investment banking sector with the bankruptcies of several historic institutions and the takeover or transformation of the remainder into commercial banks *in extremis*; the implosion of global credit markets; the forced nationalization of the European banking sector; the first synchronized global recession since WWII, with serious repercussions for Asian growth; and the bankruptcies of the entire US automobile and collapse of the housing industry, along with a radical slowdown in global industrial production sending commodity and energy prices crashing some 50-75% in a matter of months.

While events in Russia will obviously be affected by the global context, policy decisions will also be a primary determinant of the outcome. Having gotten a bit of a scare in early Q4 2008, we are now relatively confident that – perhaps after having exhausted the available alternatives – Russian economic policy is broadly speaking proactive and broadly appropriate. We are a long way from the policy chaos of 1998.

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<sup>8</sup> (the initial implosion of the asset bubble (phase I) led to a wave of institutional collapse (II), leaving the industrialized economies threatened with a spiral into depression (III)).

## What happened?

We readily acknowledge that we were taken by surprise by the havoc in the Russian economy. Russia had been motoring along quite nicely when it was suddenly blind-sided by the combination of a historic collapse in commodity prices and the sudden, radical drying up of all global credit. As Roland Nash put it, *"in August, Moscow hotels were packed with Western bankers desperate to lend to Russian corporations - by October, the same corporates could not even roll over their maturing credit lines."* Similarly, while a 75% collapse in the price of the main export product would have seriously affected any commodity producer, the high export dependency of Russia increased said vulnerability. Given the combination of these two shocks, it is a testament to the quality of Russian macroeconomic policy adjustments that the crisis has not been far worse.

The benefits of globalization have become a fundamental pillar of the current liberal economic orthodoxy. Leaving aside any theoretical discussions as to whether there is a better alternative, the wild volatility of globalized capital flows has had devastating effects upon emerging economies. Latin America's impressive progress of the past decade is now seriously imperilled – while EMEA is faced with anything between very damaging recessions (Lithuania and Estonia, Czech Republic and Poland, Kazakhstan) to outright collapse (potentially including Ukraine, Hungary, Latvia, Pakistan and Georgia). Currencies (Brazilian Real, Turkish Lira, Indian Rupiah, SAR, and even the Australian, New Zealand and Canadian dollars) were driven to unsustainable overvaluations by successive waves of hot money, then left to crash following the sudden withdrawal of hot money.

Similarly, for commodity producers, over the past decades any rational allocation of Capex for mineral extraction projects in the context of uncontrolled price volatility was more a matter of luck than of skill. As prices plunge, hundreds of billions of dollar in misallocated investment will be allowed to rust, setting the world up for another explosive rise in prices, some years down the line.

## Three Horsemen – Rouble, Bond and Oligarchs

*Some of the widely-reported events having a significant impact upon the Russian markets include the bankruptcy or near-bankruptcy of some of Russia's richest men, the sudden attack upon the rouble and Russia's on-off relationship with OPEC.*

### -The Autumn of the Oligarch

*Somewhere deep within the genetic code of every Russian is the knowledge that no man is entirely safe from the spectre of the beggar's bowl or the dungeon.*

*The great free-for-all characterizing the 1990s redistribution of Soviet assets led to the emergence of the smartest, luckiest, and often, the most unscrupulous and brutal players as a new political class - "The Oligarchs". This first generation enriched itself primarily via the notoriously corrupt "loans-for-shares" deals – by which they acquired the ownership of the crown jewels of Soviet industry at a tiny fraction of fair value – in return for very modest loans, employed in the Oligarch interests by ensuring Yeltsin's (probably fraudulent) reelection.*

*A fair number of Russia's first generation of oligarchs – hunter-gatherers and raiders to a man – perished in the 1998 default/ devaluation. Several of the most rapacious survived a few short years longer, before being driven into exile or prison as President Putin broke their political stranglehold, reducing the remainder to mere moguls, devoid of any avowed political ambitions.*

*The survivors shifted their interests from political power plays to the accumulation of capital. The ensuing years were generally kind to the Oligarchs, as Russia enjoyed a period of unprecedented economic growth and stability, which alongside a favourable tax regime and surging commodity prices, swelled both their ranks and their fortunes.*

*Furthermore, with their economic incentives gradually shifting as the system became more rational, quite a number of these erstwhile raiders settled down to work the land – consolidating their holdings and investing into industrial production.*

*Alas, Irrational exuberance thrives in the Russian soil no less than in milder climes; given their robustly competitive spirits, a fair number availed themselves of the rush by foreign lenders to provide near-unlimited*

*secured debt finance to Russian entities, fuelling a bare-knuckled competition for a spot at the top of the Oligarch Roster (i.e. Forbes' Richest People – Russia.) A fair number of them now appear to have leveraged themselves into economic extinction.*

The deadly combination of easy credit, the widely-shared illusion that prosperity would never cease, and what can only be described as the great Russian tradition of mood swings between the blackest pessimism and the wildest exuberance led to a large coterie of top Oligarchs becoming dangerously over-leveraged and thus highly exposed to equity price swings. They were caught offside by the sudden onset of the economic crisis after pledging large blocks of stock in their core holdings to the global banks, generally as security for loans used for the purchase of further assets, both in Russia and abroad.

With the likes of Deripaska and Potanin pushed deeply into margin call territory by a combination of the sudden global credit crunch and the collapse of the Russian equity market (driven largely by the forced liquidation of reposed assets) and with no alternative sources of finance available, there was a real danger that prime Russian assets would fall into the hands of foreign lenders – anathema to the Putin administration.

In order to avoid a fire-sale of pledged assets to the Western banks, the Russian administration chose to deploy sovereign reserves, either directly or via VEB, to substitute for Western credit lines to defaulting local entities. Unlike the situation in some Western countries where taxpayer finance was provided essentially gratis, the Russian bailouts were generally granted at market interest rates, and required good collateral – usually the pledged shares.

Given that the terms of the loans have been relatively short – generally 12 months – we think it likely that at least some oligarchs will be unable to reclaim their shares which will thus revert to state-controlled banks, thus resulting in a *shares-for-loans* swap, i.e. a belated reversal of the infamous loans-for-shares auctions.

Statements from various high-level officials suggest that the Russian State will retain the shares for several years, possibly restructuring the holdings before auctioning them off again. Top Putin aide Arkady Dvorkovich declared that the Russian

government was not interested in long-term ownership of the assets, however we cannot exclude the possibility that a sovereign holding company will instead be established to manage assets in sectors adjudged to be strategic.

## **-Slipping on the Oil Slick**

*We shall be a bit harsh: discussing Russia with Western commentators, we hear a great deal of nonsense – yet we have heard no single piece of pernicious idiocy that quite competes with the notion that Russia cannot possibly collaborate with OPEC for fear of losing her prized place in the G8. Apparently, some folk believe that suicide (Russia's, not their own) is not too high a price to pay to defend an alien ideology and/or to keep current one's membership in a club of sunset powers.*

*T&B was frankly appalled to read Finance Minister Kudrin's declaration<sup>9</sup> of 8 November that Russia would ignore Hugo Chavez' calls for coordinated production cuts, instead pursuing an "independent oil policy." Whilst this policy was merely wrong-headed, to declare it publicly was madness. For Russia to reject OPEC's requests on ideological grounds is the equivalent of a drowning man scorning a proffered life-jacket, choosing instead to swim freely and independently into the towering waves. In the event, the oil market dutifully tanked, dramatically impacting investor perceptions of Russian economic sustainability.*

As the world's largest oil producer, Russia has at hand the means to avert the worst effects of the global recession. We encounter a widespread (and frankly, self-serving) prejudice in the Western press that OPEC will never abide by its own rules, nor will Russia ever be anything but a free rider. In fact, this assumes that OPEC members are too stupid to understand the relative advantages of selling 9 barrels of oil at \$80, versus selling 10 barrels at \$40...a dangerous condescension.

In our view, it would be culpable insanity for Russia to refuse to provide full-fledged support to OPEC in their struggle to counterbalance the reduction in demand with a corresponding decrease in supply, bringing global oil reserves back to normal levels, and

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<sup>9</sup> *He also declared that speculators playing against the rouble would be badly disappointed, and that he was "not frightened" of oil at \$40...just what does it take to scare this guy?*

restoring oil prices to the \$70-90 range called for by the main OPEC countries.

The appointment of Igor Sechin as Russia's emissary to the Dec 17 OPEC meeting was a cause for relief, suggesting that FM Kudrin has been marginalized from oil policy. Mr. Sechin, often seen as Putin's right hand man, is the de facto head of the nationalist faction, and has been pushing for Russia to join with the cartel in supporting oil prices, vital to avoid a repeat of the catastrophic situation seen in 1997-98 when Saudi Arabia intentionally tanked prices to punish other OPEC members – in particular Venezuela – whose overproduction left it to Saudi to shoulder all of the production cuts. By the time the others finally saw the light and stopped cheating, oil had briefly dipped below \$10 a barrel<sup>10</sup>.

A similar situation is now recurring; although the actual decline in oil consumption (in fact, a reduction in the rate of increase) is relatively modest, it has allowed reserves to increase from a normal 52 to over 56 days supply. In a finely-balanced market with limited storage capacity, a 7% increase/ decrease has a disproportionate impact upon prices. The impact of the decline in consumption was further aggravated by the speculative money coming out of the commodities futures markets, as well as by flow traders following the time-honoured principal of taking the path of least resistance. *Abyssus abyssum invocat* – the abyss calls up the abyss – and recent price action threatened to become a free-fall.

While short-term volatility is likely to continue, in the medium term, we expect oil to rebound strongly. A number of recent analytical reports from the surviving investment banks totally missed the point: while there is no denying the negative short-term factors – excessive stocks along with demand destruction due to the global slowdown, they totally neglect the long-term drivers which will eventually drive oil well past its recent peaks: the natural decline in the existing oil basins, along with secular economic growth in the developing world.

As regards the former, oil fields begin to decline from the day they are first tapped. Many of the major producers are now seeing an accelerating decline in output – Indonesia has become a net importer, while production in Mexico and the North Sea are gradually collapsing. Although major new fields will continue to be found, the easy oil has all been drilled, and new deposits will be situated in

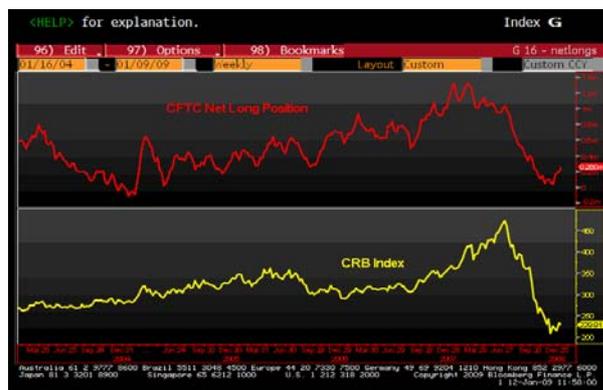
geologically challenging areas: Arctic and very deep water. Like oil sands, shale, and most of the alternatives, these will require oil prices of between \$60 - \$90 to be commercially viable.

On the demand side, while we agree that US consumption will be durably impacted by the roll-over of the economy, China continues to grow strongly – a bit slower than expected, but even the most pessimistic observers do not expect an actual decrease in GDP. Whilst Chinese per capita energy consumption is still only a tiny fraction of that of the industrialized countries, it is now at the inflection point beyond which each additional dollar of GDP translates into a substantial increase in energy consumed. 2008 saw a 9.8% increase in Chinese oil imports – 2009 should see some acceleration in the increase in volumes imported, as China takes advantage of low oil prices to rebuild reserves.

In brief, while a bout of further weakness in commodity prices cannot be excluded, we believe that the rapid destruction of supply in energy, grains and metals, along with sustained Asian economic development, are setting the stage for a renewed price surge dwarfing that seen earlier in the decade.

We would note that after massive retreat of financial players from the commodities area, they are now heavily oversold – and due for a recovery towards trend. A recent chart from Bloomberg showed a possible bottoming in net long exposure in the commodity sector. We are a bit cautious of calling a bottom with financial markets in a tailspin, but it bears watching.

from Bloomberg – Long Speculative positioning vs. CRB Index – Bottoming?



## Currencies -

### *For a Couple of Roubles More...*

*As the sudden spike in global risk aversion triggered a panicked repatriation trade resulting in a surge by both the US dollar and*

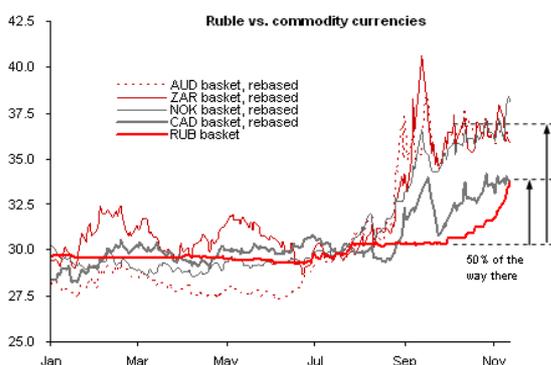
<sup>10</sup> At which time *The Economist* issued its famous prediction that it would drop as far as \$5...

*the Japanese Yen, virtually all of the high-yielding currencies came under severe pressure – with the commodity currencies seeing a particularly severe sell-off; Russia did not prove to be the exception.*

In the aftermath of the Lehman collapse, as credit suddenly became unobtainable for any but the highest rated borrowers the Russian financial system was briefly faced with the threat of a meltdown – bank runs developed, non-payments accumulated, industries shut down, while like every other commodity/high-yield currency, the rouble came under overwhelming pressure.

While the authorities moved quickly and with surprising pragmatism to protect the banking sector and prevent the crisis from snowballing out of control (improvising several of the measures eventually adopted by the US Fed), an understandable reluctance to compromise the psychological benefits of several years' domestic economic stabilization led to a failed effort to support the rouble at a level unsustainable in the absence of capital controls.

#### **In good company....**



*With thanks to Mike Boboshko, Alfa Bank*

The problem was rendered particularly acute by the virtual dual-currency nature of the Russian economy. By way of contrast, the Indonesian Rupiah and the New Zealand dollars both plunged by more than the rouble (some 40% for the Kiwi, 50% for the Rupiah) without causing any particular disquiet amongst the locals, who consider the exchange rate mostly when planning their vacations. In contrast, after the trauma of the bank failures and maxi-devaluations of the 1990s, the Russian populace remains

uniquely sensitive to the rouble-dollar rate – prominently sign-posted at exchange booths throughout every major city.

The initial response to an accelerating loss of reserves caused by foreign capital repatriation and speculation against the rouble by both Western and local banks involved expensive CBR intervention, backed by strong verbal support. This heroic defence simply resulted in the outflow of currency reserves at an unsustainable rate. Holding the rouble steady within its trading bands, the CBR gave the market a convenient target to trade against. Despite its threats and admonitions, the emergency bailout funds provided by the CBR to support the banking system were converted into dollars, and as Russian nationals began to withdraw rouble deposits from local banks for purchase hard currencies, both currency and banking crises threatened.

Very fortunately, the lessons of 1998 were assimilated, and within days of reiterating the promise of a tough defence of the rouble, the CBR reversed its tack as the first 1% widening of the trading band was announced. As we go to press, it has been widened a total of 14 times (as of January 12) with the rouble dropping 23% against the dollar, and about 15% against the basket. This adjustment has been somewhat facilitated by the fall of the USD against the Euro (local depositors are highly sensitive to the rouble-dollar rate, while they are indifferent to the valuation of the Rouble vs. the Euro or the basket); in any event, a depreciation is quite simply inevitable.

Whilst we continue to believe that a larger one-off devaluation – say 25%, followed by modest intervention to engineer a rebound correcting the overshoot, would have been cheaper and more efficient, the counter-argument is that this could have touched off a panicked flight out of the rouble. In any event, about 2/3 of the necessary devaluation has probably been accomplished already, and we believe that this adjustment will ultimately prove beneficial, limiting the “Dutch Disease.” Those companies with outstanding foreign liabilities have generally taken advantage of the slow devaluation to purchase hard currency sufficient to meet their obligations.

Provided that the government continues to support the most vulnerable segments of the population, the social effects should be limited. Depending upon oil prices and the outcome of the Ukrainian gas imbroglio, we would expect some further downside for the

ruble, followed by a gradual but sustained rebound whenever oil prices recover.

## **Good Neighbour/Bad Neighbourhood**

Despite all that has been done right since 1998, along with high commodity dependency and the weakness of the domestic financial system, the international opening of the Russian economy left her increasingly exposed to global volatility. While a pragmatic and competent CBR policy response has forestalled the imminent danger of a banking and/or a currency crisis, as well as helping to cushion the effects of the global meltdown upon the real economy, difficulties have been encountered in the attempt to build *ad hoc* a system of financial intermediation to replace the previous one centred about the recycling of government surpluses via the global banks.

As Goldman's MacFarquhar pointed out, the relative frugality of the Russia state since the crisis – coupled with the weakness of the domestic financial system – resulted in the rapid accumulation of reserves which were then intermediated to the real sector via the G7 banks.

The vulnerability of this system has now become obvious – the supposedly-safe US Agency assets were briefly threatened with downgrade, while the global banks are now in full crisis mode, pulling their credit lines and leaving the Russian corporate sector entirely dependent upon the State which has been forced to substitute for the foreign banks.

Any country would be challenged to improvise an entirely new financial system during times of extreme financial stress, and the well-know dysfunctionalities of the Russian administration do not render matters any easier. That said, despite the limited transparency and occasional abuses, the bailout has thus far proceeded far better than could have been expected.

It remains our view that the opening up of the Russian capital account and abolition of currency controls in 2007 – meant as a message that Russia now had a “normal economy” and was joining the supposedly beneficent and well-regulated world of modern finance – was deeply misguided and potentially dangerous.

The lifting of all capital controls resulted in a torrential inflow of global hot money to hitting the domestic market, forcing the Russian Central bank to adopt inappropriate monetary

policy so as to forestall uncontrollable Rouble appreciation. The ensuing collapse of global risk tolerance in the aftermath of the Lehman bankruptcy caused the sudden reversal of capital flows, shifting the pressure on the rouble from gradual appreciation towards violent depreciation.

This is not to suggest that a near-term resurrection of Russian capital controls is either likely or desirable. If controls are to be instituted at all, they should be applied to inflows rather than outflows, and thus, can only be instituted at times of relative calm – when money is flooding in, not out. At the present time, Russia must cleave to economic orthodoxy, though perhaps reflecting on a repositioning once the crisis passes.

## Reapplying for our Contrarian Credentials

*After a long period in which everyone in the financial community appeared to be singing from the same hymnal, T&B is not unhappy to once again take leave of the consensus.*

## Life After Debt

Keeping some sense of perspective is a challenge, however from the Russian standpoint, the current financial dislocation is several orders of magnitude less severe than that encountered in 1998 – which was itself only a pale shadow of the devastating post-Soviet collapse of the early 1990s. Unlike the 1998 debacle, the current crisis is primarily an import – global contagion following the implosion of a US financial bubble which tanked commodity prices and caused a sudden reversal of the wave of hot money flowing into Russia.

From late 2007 T&B has been moderately bearish on Russian equities (admittedly, not due to fundamental concerns with Russian economic trends, but rather, due to our fear of a sharp sell-off in the G7 equity markets), preferring the bond market which is generally more sensitive to the economic fundamentals, less to investor sentiment.

In the event, we clearly underestimated the potential for the expected US economic crisis to affect Russian economic fundamentals. The policy of opening the Russian financial sector to global capital flows – which helped to fund industrial and infrastructure expansion during the last throes of the global bull market – also led to a dangerous degree of financial vulnerability as global liquidity imploded.

A potentially catastrophic payments crisis in the aftermath of the Lehman's debacle was averted thanks to rapid and decisive action by the FinMin/Central Bank. That said, industrial production and employment have fallen sharply, with GDP growth likely to stagnate this year – although an actual recession can probably be averted thanks to government support for consumption. After a decade of austerity, this support can be funded not by deficit spending, but rather, by use of reserves accumulated for just such a rainy day.

## How to Trade it – Picking through the Rubble

*When, in recent years, some of our peers lamented how unfortunate it was that the great buying opportunities of 1998-99 were gone, never to return, T&B agreed – though churlishly adding that, if somehow said opportunities were to miraculously recur, they would all be too s... scared to buy the suddenly-cheap assets – which had looked so appealing when priced for perfection. And so it transpires...*

Investors with a conservative outlook will currently prefer the hard currency fixed income assets of Russian sub-sovereign borrowers. The more adventurous will take a punt on the larger cap equities, paying close attention to cash flows and the likelihood of government support. Only the frankly suicidal will venture out into the local currency bond market – a major disappointment for all involved.

## Trading the Global Dry Spell

*Traders accustomed to the unprecedented liquidity of financial markets, both emerging and G7, over recent years shall have to revise their trading styles. The hedge funds are in a death-spiral, pulling trillions in liquidity from the markets, leverage has been slashed, while the global banks are in the process of shuttering their prop trading desks. As liquidity dries up there is no longer any real price for large segments of various asset classes, (especially in spread product, where many bonds now trade on price rather than on yield).*

As regards Russia, in October-November sovereign CDS soared into the 4-digits, as the sub-sovereign/corporate CDS market disappeared, and panicked fund managers rushed to buy the only protection they could so as to hedge out at least the sovereign risk component<sup>11</sup> of their suddenly-illiquid corporate or sub-sovereign positions. Meanwhile, the underlying assets literally had no price – no one was making markets, and the bonds traded, if at all, well below the bid, and totally uncorrelated with the fairly modest underlying risk.

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<sup>11</sup> Yes, said "hedging" was patently absurd – the risk was concentrated at the corporate level – there was no meaningful sovereign risk...but try explaining that to a panicked credit committee gone into survival mode.

A few months later and pricing has become a bit more rational – although the slow bounce and the still-wide spreads reflect the radically pared population of market-makers, with the survivors constrained by their much-reduced trading lines.

Although liquidity is still very poor, this may actually prove a boon for anyone armed with a little cash and a lot of patience. Given the vastly reduced activity of the hedgies and prop desks, assets can become grossly mispriced without this mispricing being immediately arbed out. It is thus an occasion for some old-fashioned investing: as in, find an asset you like, buy it, own it, enjoying slow, steady returns. Welcome to the future!

### Russia - Bearing Up/Bearing Down

Looking around, there are excellent reasons to be pessimistic, though as regards Russia, the market has priced in not just the bearish scenario, but a disaster rivalling 1998. While a truly dire outcome cannot formally be excluded – **either in Russia or anywhere else** – we think it very unlikely. Russia has a God-given ability to muddle through, a focused and purposeful government<sup>12</sup>, self-sufficiency in all vital resources, and a very sizeable bank account.

Most of all, however, the views expressed by the mainstream Western observers now remind us of the period following the fall of the main exponent of the of Washington consensus in the Russian oil business – Mikhail Khodorkovsky. In finance, we make money trading against misinformation, prejudice and irrational fear/exuberance; investors who braved the consensus in 2003 were generously rewarded – those who waited to join the pack in early 2007 made out rather less well.

Thus, for the first time in several years, we are afforded an opportunity to be contrarian. Again, no sane person would claim that all is well and that there is nothing to worry about – simply, we find the ambient pessimism grossly overdone. There are a number of actions that Russia can take to defend its position – further devaluation (preferably not of the Chinese water torture variety), refinancing of corporate borrowings with sovereign funds, targeted support of the real economy, fiscal policy to maintain consumption by the poorest

sectors of society, and especially, support for OPEC.

Having exhausted the available alternatives, policy now appears to be broadly appropriate. While our suggestion that Russia might prove to be at least a relative haven of stability now seems an eminently forgettable call, we are not ready to entirely abandon our position... *It ain't over till its over!*

- **Rouble Bond Market – Dead Again**

One of the worst, ongoing policy blunders in the response of the Russian authorities to the financial crisis has been to abandon the rouble-denominated bond market to its sorry fate – standing by passively as business practices last seen in the 1998 crisis again become prevalent, allowing a vital mechanism for the intermediation of savings to the middle-tier corporate sector to collapse. There is precedent:

In 1998, after a decade of catastrophic economic mismanagement, at least partially attributable to the misguided advice of the IMF and a well-intentioned but ideologically blinkered Clinton administration, Russia was compelled to allow an extreme devaluation of the rouble, which ultimately fell by as much as 80%, leading to the collapse of the banking system and a default on internal sovereign debt (the GKO/OFZs). Vitally – perhaps as an expression of national pride and despite severe economic hardship – the decision was made to draw a distinction between internal and external debt, with all official Russian (i.e. post-Soviet) external obligations serviced scrupulously.

Obviously, the situation today is fundamentally different from that of 1998 (there is now a functioning government, Central Bank and tax system; sovereign reserves are huge; the rouble is not wildly overvalued and is being allowed to devalue gradually; and especially, the banking sector does not suffer from a massive currency mismatch.) That said, there is a disquieting analogy as regards the sovereign indifference of the Russian State to the collapse of its domestic non-bank financial sector. This is particularly unfortunate given that the weakness of the Russian banking sector meant that the rouble bond market became the key mechanism for financing middle-tier corporates unable to access international financial flows. As the rouble bond market

<sup>12</sup> *alas, with the communications skills of an introvertedcatatonic...*

crumbles into default, we fear that the damage will be long to repair.

The Russian rouble sub-investment-grade bond market is now effectively dead – following a wave of defaults by third- and fourth-tier borrowers, many of them fraudulent, the lack of effective legal redress by creditors means that all trust is evaporating. While the initial defaults were by marginal borrowers, some of whom apparently lacked not so much the means as the desire to pay, over the past month larger and presumably more reliable companies have gone into default, e.g. Nutritek and Evrokommerz – the latter floated by one of the most trusted local financial institutions, which provided a level of credibility and comfort which has proved hollow.

Given the depreciating currency with very limited visibility as regards its likely terminal valuation, even the first/second tier of the rouble bond market is now confined to trapped pools of rouble liquidity, i.e. institutions and investors limited to owning local assets.

- **De-regulation, po' Russkiye**

Russian regulators were seriously negligent in allowing the domestic debt market to develop in the absence of adequate legal guarantees, proper bond covenants, or appropriately codified bankruptcy law and practice. Despite these obvious failings, for as long as a steadily appreciating rouble and the global dash for yield kept local liquidity pumped up, the rouble bond market grew steadily, eventually becoming the main cash pump for Russian mid-cap companies – which were briefly able to borrow short-term money at strongly negative real interest rates.

This montage was dangerously dependent upon the global carry trade, i.e. the continued inflow of hot money; with the wisdom of hindsight, it was an accident waiting to happen. The trigger was of course the collapse of the US financial system, the practices and regulation of which eventually deteriorated to a degree almost unprecedented amongst modern industrial economies (indeed, which would have left the finance ministers of Ecuador or Nigeria quaking with fear).

The bursting of the global credit bubble triggered a sudden liquidity crisis leaving all Russian companies, even the best-managed and most prudent, dangerously squeezed for liquidity. Fear stalked the markets – Russian 5Y CDS briefly spiked to almost 1200, market makers ceased to make markets, while new issuance required to roll over maturing debt was precluded.

Coupled with widespread expectations of rouble devaluation – not credibly addressed by the monetary machismo of the CBR – the rouble debt market simply froze up, with the only new issuance being “technical issues”, i.e. issuance intended solely for repo to the Central Bank. At the present time, companies are unable to roll-over maturing debt, and having seen the markets closed to them for the foreseeable future, a few black sheep have taken the simple expedient of defaulting on maturing debt, harkening back to corporate governance practices last seen in the late 1990s.

This regulatory negligence is likely to prove very costly to the real economy. Given the weakness of the Russian banking system and the very limited economic relevance of the stock market – as well as, more generally, the lack of domestic long-term investment capital, the rouble bond market came to constitute a vital avenue for capital raising by Russian mid-cap companies. It is now effectively closed, and will not reopen before the economy stabilizes and especially, before thoroughgoing and credible regulatory and bankruptcy reform are carried out.

For now, as market failure has removed any realistic hope of refinancing and thus the major incentive to avoid reputational damage, and absent a more interventionist stance by the Russian State, a further wave of rouble bond defaults is to be feared.

- **Russian Foreign Currency Debt**

On the other hand, confirming the strategy outlined in our report of 17 November,<sup>13</sup> we remain very bullish on Russian foreign currency bonds, where yields of between 17%-35% are now available on a wide variety of assets. As opposed to their culpable neglect of the domestic Rouble market, the Russian authorities have rushed to assist major corporates and banks in refinancing their foreign borrowings, redeploying official reserves previously invested in low-yielding US treasuries and Agency bonds. Thus, until present there have been no Eurobond defaults – even by companies which appeared to be seriously stretched for cash.

Although spreads have already narrowed significantly, as prices have bounced by as much as 50%, there appears to be more to come. Thus, those investors not convinced that a nuclear winter is about to spread its icy wings over the global financial system, leaving us frozen like the last great woolly mammoths of the Great Extinction, may wish to avail themselves of YTM>17% on select sub-sovereign issues, >30% on top Russian private banks, >35% on top-tier resource producers, or even 11% on the sovereign bonds – perhaps unsafe, but probably no more so than US treasuries, and certainly more lucrative.

Given the economic uncertainty, the risk-averse may wish to stick as close as possible to the state, i.e. Transneft, Gazprom, VTB, Sberbank, etc. Further out the curve, the resource producers offer particularly compelling yields – the current pricing of BP-TNK greatly overstates the underlying risk, while Severstal, Evraz and Mechel are also likely to be survivors – and at least, you are certainly getting paid to take the risk.

Finally, we will reiterate our view that the CBR will continue to support the Russian banking sector under any foreseeable circumstances short of actual sovereign default. Thus, this sector may well provide the most compelling yields on a risk-adjusted basis – our old favourite, SIBAC (URSA) 8.3 of 2011 (Euros) has recovered nicely, as has Alfa bank; some of the smaller banks among the top 50 continue to price at deeply distressed levels, representing an extraordinary opportunity for risk-tolerant investors.

- **Russian Equities – You Loved me when I was Expensive...**

For the first years of this decade, T&B regularly repeated the mantra of Russia as the World's Cheapest Equity Market – far cheaper than a host of countries bearing infinitely greater macroeconomic risk. Eventually the market caught on to the mispricing – and by 2007, the RTS was priced closer to the middle of the emerging asset class.

No longer! In the wake of the global liquidity crisis, based upon IBES earnings estimates, Russia is once again far and away the lowest-priced significant equity market, trading at a **P/E of 2.9**, i.e. massively cheap to such havens of stability and probity as Indonesia, Egypt, Turkey, India and yes, Pakistan. Amazingly, Argentina, often described as “a *serial macroeconomic accident going somewhere to recur*,” enjoys a P/E three times that of Russia!

The technical reasons are several-fold – the absence of a domestic institutional investor base providing some buffer when the hedge funds take flight, the forced liquidation of equity positions repoed by weak hands and over-enthusiastic oligarchs, limited transparency, weak market infrastructure and especially, the systematically negative coverage in the financial press.

Not that there were not some good fundamental reasons for the recent sell-off: Russian earnings will be softer in 2009, commodity prices have plunged, several corporate governance issues have rattled investors, there will be some defaults, and global risk aversion is on the rise. Our point here is that none of these phenomena are confined to Russia – corporate governance is as bad or worse in China and Indonesia, macroeconomic risk is infinitely greater in Pakistan and the Baltics, whilst risk-aversion is obviously a global phenomenon.

Equally, there were also some bad reasons for the sell-off: simple contagion, serial bouts of hysteria over a repeat of the Yukos affair (most recently as regards Mechel which, as we predicted, proved to be nothing more than a case of Russian-style anti-trust enforcement, without any threat of a government takeover), fears of social unrest, and geopolitical concerns.

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<sup>13</sup> (*Love and Bond-age, in the Time of Cholera, available on [www.truthandbeauty.ru](http://www.truthandbeauty.ru)*)

In brief, the Russian equity market offers extraordinary value, although equity markets being creatures of the heart, not like debt markets, of the mind, we are loath to offer any firm time-frame for the recovery of the RTS.

From the Russian standpoint, factors to watch for would be an end to the series of mini-devaluations, with a total drop against the basket of circa 20%, mean reversion of oil prices back to trend, an acceleration of the Russian anti-crisis program, and further clarity regarding which companies qualify for state support.

### **Looking Forward – Through a Glass, very Darkly**

*The fast shrinkage of Russia's foreign currency reserves, plummeting oil prices and the weakening ruble means that Russophobes<sup>1</sup> of all stripes are having a field day. They prophesise the collapse of the currency, soaring inflation, and the disintegration of the 'Putin system' as populist unrest undermines it from below and Siloviki clans fighting over dwindling oil rents rend it apart from above. Relying as they do on unsubstantiated claims fitted to support a flawed narrative of Russia as a virulent kleptocracy governed by economic illiterates, their predictions are once again doomed to come to naught - much like prior auguries<sup>2</sup> of fascist takeover or ethnic disintegration<sup>2</sup> after the 1998 crisis.*

Anatoli Karlin, [www.sublimeoblivion.com](http://www.sublimeoblivion.com)

-Global economics remains the great imponderable. Many of our peers have rejoined T&B in the deep Zen Buddhist refrain of "dunno"...i.e. we simply **do not know** whether the motley crew of Central Banks and Finance Ministries will somehow succeed in resurrecting Humpty Dumpty – or instead, shall we all go Japanese.

As we go to press, the New Year rebound appears to have failed convincingly – hardly surprising given the species alignment, i.e. everyman and his dog predicting a brief dead cat bounce, followed by a resumption of the bear market.

### **Dead Man Dancing**

Global market performance over the remainder of this quarter will be conditioned by the newsflow (almost certainly bad), versus market expectations of how successful will be the concerted efforts by the Central Banks and finance ministries to pump in enough monetary stimulus to make the dead not walk but dance.

Our working assumption is that, even were this stimulus to bring about a rebound, a phase of disappointment would follow as stimulus measures gain limited traction given the massive destruction of global liquidity. With a bit of luck, the second dip will be the last, and the G7 economies will bottom, probably followed by a prolonged L-shaped recovery. In this case, financial markets will anticipate the less bad news, and should see some more sustainable recovery in 3-4Q 2009.

Alas, the risks are all to the downside and there is a real possibility that we are stepping back about 80 years – into Great Depression II – in the immortal words of George Bush, "This sucker could go down"!

The Russian equity market reliably tends to be either the world's best, or the world's worst –2008 was certainly no exception. Looking forward, it would be quite a challenge to repeat last year's ~70% drop, so better days are likely on their way.

Certainly, we have acknowledged the uncertainty and will assume the risk of making fools of ourselves by reiterating our fundamentally constructive call on Russia, which, despite the dreadful global context, we expect to ultimately come through the storm rather better than most. Indeed, over the medium term, she may prove to be one of the relative winners in the reshuffle of the global deck – now getting underway in earnest.

**Appendices Begin Overleaf – Page 26  
Fairly voluminous this time, we think they  
are eminently worth perusing.**

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## Appendix I – The First Holes Appear in the Dyke

*The collapse of Washington-sponsored narrative began when the BBC was finally acknowledged that it had been egregiously manipulated ...2 months after the shooting stopped.*

### Did Georgia commit crimes in South Ossetia?

By Tim Whewell

BBC File On 4 Last updated: 28 Oct 2008

*The BBC has discovered evidence that Georgia may have committed war crimes in its attack on its breakaway region of South Ossetia in August.*

Eyewitnesses have described how its tanks fired directly into an apartment block, and how civilians were shot at as they tried to escape the fighting. Research by the international investigative organisation Human Rights Watch also points to indiscriminate use of force by the Georgian military, and the possible deliberate targeting of civilians.

Indiscriminate use of force is a violation of the Geneva Conventions, and serious violations are considered to be war crimes.

The allegations are now raising concerns among Georgia's supporters in the West.

British Foreign Secretary David Miliband has told the BBC the attack on South Ossetia was "reckless".

He said he had raised the issue of possible Georgian war crimes with the government in Tbilisi.

The evidence was gathered by the BBC on the first unrestricted visit to South Ossetia by a foreign news organisation since the conflict.

Georgia's attempt to re-conquer the territory triggered a Russian invasion and the most serious crisis in relations between the Kremlin and the West since the Cold War.

And Georgians themselves have suffered. We confirmed the systematic destruction of former Georgian villages inside South Ossetia. Some homes appear to have been not just burned by Ossetians, but also bulldozed by the territory's Russian-backed authorities.

The war began when Georgia launched artillery attacks on targets in the South Ossetian capital, Tskhinvali, at about 2330 on 7 August 2008. Georgia said at the time that it was responding to increasing attacks on its own villages by South Ossetian militia, although it later said its action was provoked by an earlier Russian invasion.

Eye-witness account

Georgy Tadtayev, a 21-year-old dental student, was one of the Ossetian civilians killed during the fighting.

His mother, Taya Sitnik, 45, a college lecturer, told the BBC he bled to death in her arms on the morning of 9

August after a fragment from a Georgian tank shell hit him in the throat as they were both sheltering from artillery fire in the basement of her block of flats.

Mrs Sitnik said she subsequently saw the tank positioned a few metres from the building, firing shells into every floor. Extensive damage to the five-storey block appeared consistent with her version of events. She said she and her son were watching television when the Georgian attack began.

"They started firing not from rifles, but from heavy weapons. Shells were exploding."

"We jumped up straight away, switched off the lights and ran down to the cellar."



Dr Marina Kochieva says her car was targeted by a Georgian tank



“ They went on firing all the next day without stopping. At some point there was a pause, and we saw Georgian soldiers going along the street in their Nato uniforms ”

Taya Sitnik

"And we sat here on boxes. We thought it would end, but the firing got heavier and heavier," she added. "They went on firing all the next day without stopping. At some point there was a pause, and we saw Georgian soldiers going along the street in their Nato uniforms," according to Mrs Sitnik.

"Then they started firing again, even more heavily. The Grad rockets were coming over all the time."

"How can you trust those people now? What possible friendship can there be? Let them all be cursed, cursed for the deaths of our children."

Neighbours said another resident of the block, Khazbi Gagloyev, also died of wounds received during the attacks.

'Basements targeted'

The Russian prosecutor's office is investigating more than 300 possible cases of civilians killed by the Georgian military.

Some of those may be Ossetian paramilitaries, but Human Rights Watch believes the figure of 300-400 civilians is a "useful starting point".

That would represent more than 1% of the population of Tskhinvali - the equivalent of 70,000 deaths in London.

Allison Gill, director of the Moscow office of Human Rights Watch, said: "We're very concerned at the use of indiscriminate force by the Georgian military in Tskhinvali.

"Tskhinvali is a densely populated city and as such military action needs to be very careful that it doesn't endanger civilians."

"We know that in the early stages there were tank attacks and Grad rockets used by Georgian forces," she added.

"Grad rockets cannot be used in densely populated areas because they cannot be precisely targeted, and as such they are inherently indiscriminate.

"Our researchers were on the ground in Tskhinvali as early as 12 August.

"And we gained evidence and witness testimony of Grad rocket attacks and tank attacks on apartment buildings, including tank attacks that shot at the basement level.

"And basements are typically areas where civilians will hide for their own protection.

"So all of this points to the misuse, the inappropriate use of force by Georgia against civilian targets," according to Alison Gill.

Human Rights Watch will talk only of the "possible" deliberate targeting by Georgian forces of individual civilians, a still more serious charge, though some Ossetians the BBC spoke to in Tskhinvali claim to have witnessed such cases.

Wreckage

Marina Kochieva, a doctor at Tskhinvali's main hospital, says she herself was targeted by a Georgian tank as she and three relatives were trying to escape by car from the town on the night of 9 August. She says the tank fired on her car and two other vehicles, forcing them to crash into a ditch. The firing continued as she and her companions lay on the ground.

She showed the BBC the burnt-out wreckage of the car on the town's ring-road, riddled with bullet holes and with a much larger hole, apparently from a tank round, in the front passenger door.

Ms Kochieva says a nurse from her hospital was killed while fleeing Tskhinvali in similar circumstances.

She says she counted 18 burnt-out cars on the ring-road on 13 August, at the end of the war, suggesting there may have been more casualties.

Asked if, at night, Georgian soldiers might not have suspected her car of carrying Ossetian fighters, Ms Kochieva said: "Fighters wouldn't have gone away from town, they would have gone towards town. We were escaping like other refugees.

"The Georgians knew this was the 'Road of Life' for Ossetians. They were sitting here waiting to kill us," she said.

Georgia's Foreign Minister Eka Tkeshelashvili told the BBC, "I can firmly say that the Georgian military, on intention, never attacked directly any civilian object.

"On the surface, the damage to some of the houses in Tskhinvali that can be observed might lead to this conclusion. But to see if some is damage inflicted by direct targeting, for that an in-depth military assessment needs to be done.

"I think the best response is a fully-fledged independent, impartial international inquiry into the issue," she added. Her British counterpart David Miliband, who visited Georgia immediately after the war to show solidarity with its government, said he took the allegations of war crimes "extremely seriously" and had raised them "at the highest level" in Tbilisi.

Apparently hardening his language towards Georgia, he called its actions "reckless". But he added: "The Russian response was reckless and wrong".

"It's important that the Russian narrative cannot start with Georgian actions; it has to start with the attacks on the Georgians from the South Ossetians and that is the tit-for-tat that got out of control," he said.

#### Revenge

The BBC saw evidence of the cycle of revenge since the war, with the demolition of most houses in the former ethnic Georgian villages on the northern outskirts of Tskhinvali.

The houses, whose occupants fled during the war to other parts of Georgia, were burnt by Ossetians immediately after the fighting.

They are now expected to be replaced by a brand-new housing complex with a cinema and sports facilities to be financed by the city of Moscow.

Zaur Gagloyev, a 20-year-old former law student, now unemployed, claimed he was one of those responsible for the burning.

"There were so many provocations in these villages by Georgians," he said.

"For example, they were taking Ossetians as hostages and that's why I feel so angry."

Mr Gagloyev added: "If you want an advice on how to burn a house, just set light to a curtain and the whole house will catch fire."

Asked if he was guilty of ethnic cleansing, he replied, "No, it wasn't ethnic cleansing.

"No-one was killed there. We just let them go from our land. I don't know whether they will return or not," he added. "But I did everything I could for them not to return. Never. You can call it ethnic cleaning, but I think I just did it to prevent a future war," he said.



Many Tskhinvali buildings were damaged during the conflict



“ No, it wasn't ethnic cleansing... we just let them go from our land ”

Zaur Gagloyev

## Appendix II - The Atlantic Narrative Crumbles

*While it is laudable that some members of the press finally acknowledged what should have been obvious from the start – that it had been egregiously manipulated by the Georgians and their US allies, this belated admission came too late to make any real difference, and especially, was not accompanied by any apology much less a fundamental rethink of the equally fraudulent reporting about Russia in numerous other contexts.*

### Georgia Claims on Russia War Called Into Question

New York Times

Published: November 6, 2008

TBILISI, Georgia — Newly available accounts by independent military observers of the beginning of the war between Georgia and Russia this summer call into question the longstanding Georgian assertion that it was acting defensively against separatist and Russian aggression.

Instead, the accounts suggest that Georgia's inexperienced military attacked the isolated separatist capital of Tskhinvali on Aug. 7 with indiscriminate artillery and rocket fire, exposing civilians, Russian peacekeepers and unarmed monitors to harm.

The accounts are neither fully conclusive nor broad enough to settle the many lingering disputes over blame in a war that hardened relations between the Kremlin and the West. But they raise questions about the accuracy and honesty of Georgia's insistence that its shelling of Tskhinvali, the capital of the breakaway region of South Ossetia, was a precise operation. Georgia has variously defended the shelling as necessary to stop heavy Ossetian shelling of Georgian villages, bring order to the region or counter a Russian invasion.

President Mikheil Saakashvili of Georgia has characterized the attack as a precise and defensive act. But according to observations of the monitors, documented Aug. 7 and Aug. 8, Georgian artillery rounds and rockets were falling throughout the city at intervals of 15 to 20 seconds between explosions, and within the first hour of the bombardment at least 48 rounds landed in a civilian area. The monitors have also said they were unable to verify that ethnic Georgian villages were under heavy bombardment that evening, calling to question one of Mr. Saakashvili's main justifications for the attack.

Senior Georgian officials contest these accounts, and have urged Western governments to discount them. "That information, I don't know what it is and how it is confirmed," said Giga Bokeria, Georgia's deputy foreign minister. "There is such an amount of evidence of continuous attacks on Georgian-controlled villages and so much evidence of Russian military buildup, it doesn't change in any case the general picture of events."

He added: "Who was counting those explosions? It sounds a bit peculiar."

The Kremlin has embraced the monitors' observations, which, according to a written statement from Grigory Karasin, Russia's deputy foreign minister, reflect "the actual course of events prior to Georgia's aggression." He added that the accounts "refute" allegations by Tbilisi of bombardments that he called mythical.

The monitors were members of an international team working under the mandate of the Organization for Security and Cooperation in Europe, or O.S.C.E. A multilateral organization with 56 member states, the group has monitored the conflict since a previous cease-fire agreement in the 1990s.

The observations by the monitors, including a Finnish major, a Belarussian airborne captain and a Polish civilian, have been the subject of two confidential briefings to diplomats in Tbilisi, the Georgian capital, one in August and the other in October. Summaries were shared with The New York Times by people in attendance at both. Details were then confirmed by three Western diplomats and a Russian, and were not disputed by the O.S.C.E.'s mission in Tbilisi, which was provided with a written summary of the observations.

Mr. Saakashvili, who has compared Russia's incursion into Georgia to the Nazi annexations in Europe in 1938 and the Soviet suppression of Prague in 1968, faces domestic unease with his leadership and skepticism about his judgment from Western governments.

The brief war was a disaster for Georgia. The attack backfired. Georgia's army was humiliated as Russian forces overwhelmed its brigades, seized and looted their bases, captured their equipment and roamed the country's roads at will. Villages that Georgia vowed to save were ransacked and cleared of their populations by irregular Ossetian, Chechen and Cossack forces, and several were burned to the ground.

### **Massing of Weapons**

According to the monitors, an O.S.C.E. patrol at 3 p.m. on Aug. 7 saw large numbers of Georgian artillery and grad rocket launchers massing on roads north of Gori, just south of the enclave.

At 6:10 p.m., the monitors were told by Russian peacekeepers of suspected Georgian artillery fire on Khetagurovo, an Ossetian village; this report was not independently confirmed, and Georgia declared a unilateral cease-fire shortly thereafter, about 7 p.m. During a news broadcast that began at 11 p.m., Georgia announced that Georgian villages were being shelled, and declared an operation "to restore constitutional order" in South Ossetia. The bombardment of Tskhinvali started soon after the broadcast.

According to the monitors, however, no shelling of Georgian villages could be heard in the hours before the Georgian bombardment. At least two of the four villages that Georgia has since said were under fire were near the observers' office in Tskhinvali, and the monitors there likely would have heard artillery fire nearby.

Moreover, the observers made a record of the rounds exploding after Georgia's bombardment began at 11:35 p.m. At 11:45 p.m., rounds were exploding at intervals of 15 to 20 seconds between impacts, they noted.

At 12:15 a.m. on Aug. 8, Gen. Maj. Marat M. Kulakhmetov, commander of Russian peacekeepers in the enclave, reported to the monitors that his unit had casualties, indicating that Russian soldiers had come under fire.

By 12:35 a.m. the observers had recorded at least 100 heavy rounds exploding across Tskhinvali, including 48 close to the observers' office, which is in a civilian area and was damaged.

Col. Gen. Anatoly Nogovitsyn, a spokesman for the Russian Defense Ministry, said that by morning on Aug. 8 two Russian soldiers had been killed and five wounded. Two senior Western military officers stationed in Georgia, speaking on condition of anonymity because they work with Georgia's military, said that whatever Russia's behavior in or intentions for the enclave, once Georgia's artillery or rockets struck Russian positions, conflict with Russia was all but inevitable. This clear risk, they said, made Georgia's attack dangerous and unwise.

Senior Georgia officials, a group with scant military experience and personal loyalties to Mr. Saakashvili, have said that much of the damage to Tskhinvali was caused in combat between its soldiers and separatists, or by Russian airstrikes and bombardments in its counterattack the next day. As for its broader shelling of the city, Georgia has told Western diplomats that Ossetians hid weapons in civilian buildings, making them legitimate targets.

"The Georgians have been quite clear that they were shelling targets — the mayor's office, police headquarters — that had been used for military purposes," said Matthew J. Bryza, a deputy assistant secretary of state and one of Mr. Saakashvili's vocal supporters in Washington.

Those claims have not been independently verified, and Georgia's account was disputed by Ryan Grist, a former British Army captain who was the senior O.S.C.E. representative

in Georgia when the war broke out. Mr. Grist said that he was in constant contact that night with all sides, with the office in Tskhinvali and with Wing Commander Stephen Young, the retired British military officer who leads the monitoring team.

“It was clear to me that the attack was completely indiscriminate and disproportionate to any, if indeed there had been any, provocation,” Mr. Grist said. “The attack was clearly, in my mind, an indiscriminate attack on the town, as a town.”

Mr. Grist has served as a military officer or diplomat in Northern Ireland, Cyprus, Kosovo and Yugoslavia. In August, after the Georgian foreign minister, Eka Tkeshelashvili, who has no military experience, assured diplomats in Tbilisi that the attack was measured and discriminate, Mr. Grist gave a briefing to diplomats from the European Union that drew from the monitors’ observations and included his assessments. He then soon resigned under unclear circumstances.

A second briefing was led by Commander Young in October for military attachés visiting Georgia. At the meeting, according to a person in attendance, Commander Young stood by the monitors’ assessment that Georgian villages had not been extensively shelled on the evening or night of Aug. 7. “If there had been heavy shelling in areas that Georgia claimed were shelled, then our people would have heard it, and they didn’t,” Commander Young said, according to the person who attended. “They heard only occasional small-arms fire.”

The O.S.C.E turned down a request by The Times to interview Commander Young and the monitors, saying they worked in sensitive jobs and would not be publicly engaged in this disagreement.

### **Grievances and Exaggeration**

Disentangling the Russian and Georgian accounts has been complicated. The violence along the enclave’s boundaries that had occurred in recent summers was more widespread this year, and in the days before Aug. 7 there had been shelling of Georgian villages. Tensions had been soaring.

Each side has fresh lists of grievances about the other, which they insist are decisive. But both sides also have a record of misstatement and exaggeration, which includes circulating casualty estimates that have not withstood independent examination. With the international standing of both Russia and Georgia damaged, the public relations battle has been intensive.

Russian military units have been implicated in destruction of civilian property and accused by Georgia of participating with Ossetian militias in a campaign of ethnic cleansing. Russia and South Ossetia have accused Georgia of attacking Ossetian civilians. But a critical and as yet unanswered question has been what changed for Georgia between 7 p.m. on Aug 7, when Mr. Saakashvili declared a cease-fire, and 11:30 p.m., when he says he ordered the attack. The Russian and Ossetian governments have said the cease-fire was a ruse used to position rockets and artillery for the assault.

That view is widely held by Ossetians. Civilians repeatedly reported resting at home after the cease-fire broadcast by Mr. Saakashvili. Emeliya B. Dzhoyeva, 68, was home with her husband, Felix, 70, when the bombardment began. He lost his left arm below the elbow and suffered burns to his right arm and torso. “Saakashvili told us that nothing would happen,” she said. “So we all just went to bed.”

Neither Georgia nor its Western allies have as yet provided conclusive evidence that Russia was invading the country or that the situation for Georgians in the Ossetian zone was so dire that a large-scale military attack was necessary, as Mr. Saakashvili insists. Georgia has released telephone intercepts indicating that a Russian armored column apparently entered the enclave from Russia early on the Aug. 7, which would be a

violation of the peacekeeping rules. Georgia said the column marked the beginning of an invasion. But the intercepts did not show the column's size, composition or mission, and there has not been evidence that it was engaged with Georgian forces until many hours after the Georgian bombardment; Russia insists it was simply a routine logistics train or troop rotation.

### **Unclear Accounts of Shelling**

Interviews by The Times have found a mixed picture on the question of whether Georgian villages were shelled after Mr. Saakashvili declared the cease-fire. Residents of the village of Zemo Nigozi, one of the villages that Georgia has said was under heavy fire, said they were shelled from 6 p.m. on, supporting Georgian statements.

In two other villages, interviews did not support Georgian claims. In Avnevi, several residents said the shelling stopped before the cease-fire and did not resume until roughly the same time as the Georgian bombardment. In Tamarasheni, some residents said they were lightly shelled on the evening of Aug. 7, but felt safe enough not to retreat to their basements. Others said they were not shelled until Aug 9.

With a paucity of reliable and unbiased information available, the O.S.C.E. observations put the United States in a potentially difficult position. The United States, Mr. Saakashvili's principal source of international support, has for years accepted the organization's conclusions and praised its professionalism. Mr. Bryza refrained from passing judgment on the conflicting accounts.

"I wasn't there," he said, referring to the battle. "We didn't have people there. But the O.S.C.E. really has been our benchmark on many things over the years."

The O.S.C.E. itself, while refusing to discuss its internal findings, stood by the accuracy of its work but urged caution in interpreting it too broadly. "We are confident that all O.S.C.E. observations are expert, accurate and unbiased," Martha Freeman, a spokeswoman, said in an e-mail message. "However, monitoring activities in certain areas at certain times cannot be taken in isolation to provide a comprehensive account."

### **Appendix III – Some Folk are a bit harder to Fool...**

*Mark Ames, former editor of Moscow's defunct eXile, provides a typically incisive and (especially, concise) review of the reporting on the conflict – which he happened to have witnessed personally.*

#### **The Nation : Journalistic Malpractice**

Posted: 09 Jan 2009 02:28 PM CST

by Mark Ames

From the moment Georgia launched its invasion against the breakaway region of South Ossetia this past August, sparking a wider war with neighboring Russia, the New York Times's news coverage depicted Georgia as an innocent victim of Russia's neo-imperialist evil. In doing so, the Times engaged in the sort of media malpractice that it promised its readers wouldn't happen again after its disastrous coverage of the lead-up to the Iraq War.

Probably no article captures how the Times took on the role of Georgia's public-relations conduit better than correspondent Andrew Kramer's puff piece on Georgia's leader, Mikheil Saakashvili, "Rebuke of a President, in the Boom of Artillery," published just four days after Georgia invaded South Ossetia.

The article glorifies Saakashvili's alleged bravery under fire, claiming that his biggest fault was that he loved America too much, glossing over his widely criticized crackdown on opposition media and protesters; worse, Kramer claims that Saakashvili used only "soft power," while Russia wielded "all the hard power," in the war.

The Times stuck to its version of events for three months. It wasn't until the November 7 front-page story, "Georgia Claims on Russia War Called Into Question," that the newspaper essentially retracted its earlier reporting:

"Newly available accounts by independent military observers of the beginning of the war between Georgia and Russia this summer call into question the longstanding Georgian assertion that it was acting defensively against separatist and Russian aggression.

"Instead, the accounts suggest that Georgia's inexperienced military attacked the isolated separatist capital of Tskhinvali on Aug. 7 with indiscriminate artillery and rocket fire, exposing civilians, Russian peacekeepers and unarmed monitors to harm."

Indeed. What the Times really should have asked, but so far hasn't, is this: with so many reporters on the ground during the war, why did it take three months for the paper to get to the true version of events?

I can answer at least part of that question, because I was in South Ossetia covering the war for The Nation and Radar magazine. I saw how the Times generated articles from the Ossetian front and how its pro-Georgian slant drove its news reporting. And here is what I can tell you about the way this extremely important foreign story was framed.

Articles don't simply "happen" or "pass through" journalists; they are the product of people and organizations with vested interests, ego interests, ambition interests and, of course, business interests. The Georgia war, and the easy way that the New York Times fell into and actively pushed the neocon line about innocent Georgia invaded by evil Russia, is a product of deliberate decisions and resource allocations that I personally witnessed, much to my horror and frustration.

## **Disparate Reports**

I first started to notice something wrong with the Western coverage shortly after I arrived in Vladikavkaz, the capital of North Ossetia, in Russia proper. The few Western correspondents in Ossetia were gathered around a table at the Vladikavkaz Hotel, gorging on food and beer after a long, miserable tour into South Ossetia's ruins. The A-list Western correspondents were reporting from the Georgian side of the conflict. They all stayed in Georgia's capital, Tblisi, in one of that city's two Marriotts or in the Sheraton Hotel, with its fantastic amenities, food and wine—leaving the squalid, Russian/Ossetian side of the war zone to be covered by the second-stringers or just plain stringers.

That's when our Kremlin minder, Sasha, appeared looking harassed and depressed. He asked us if he could join us for a few minutes. The correspondents grudgingly agreed. "I don't know what to do anymore, so I have to ask you guys honestly and openly," Sasha said. "Look, I arranged to take everyone down to [the South Ossetian capital] Tskhinvali. I showed you all of the destruction that the Georgian forces caused to the city. I didn't try to tell you what to think, because first it would be counterproductive, and secondly, why would I need to? It's so obvious what happened. And yet I get back here and now I'm seeing the stories you're filing. It's all about the poor Georgian victims, or that imperialist Russia is invading poor Georgia. You saw it yourselves! You saw what the Georgians did." He slouched forward over the table. "You're going to write what you're going to write no matter what I show you. So what's the point? Maybe I should give up." Under normal circumstances, this would be a classic Russian guilt trip. But it was clear even to us, even though we weren't positively disposed to a Russian handler, that Sasha's frustration was real. It was as if the Kremlin was so excited that for once in Putin's term, the Russians lucked into being on the good guys' side of a major news story, and it made

no sense that the “free Western media” (which the Kremlin takes much more seriously than its own cowed media) wouldn’t see the truth, that they’d do the Russian thing and twist reality into propaganda. What was so shameful and embarrassing to me, an American journalist whose own Moscow-based newspaper, The eXile, had just been driven out of existence by these same Kremlin bastards, is that Sasha was rightly frustrated. A Kremlin minder right and the Western journalists wrong? What has this world come to when the Kremlin has a better grasp of the truth than the free Western media?

That’s when Matt Siegel, a young Moscow expat who was hired a week earlier by the New York Times to serve as its stringer-correspondent covering the Russian/Ossetian side of the war, spoke up. Siegel complained to Sasha that the real problem was the way Sasha was trying to manage the Western reporters. Siegel charged that Sasha didn’t give us greater access to ethnic Georgian villages in South Ossetia; his Times editor wanted a story on crimes committed against ethnic Georgians, which seemed to be what all Western editors wanted. (Georgian grievances were in big demand from the Western media’s home offices. My first day in North Ossetia, I joined Tom Parfitt of the Guardian and Andrew Osborn of the Wall Street Journal, driving around ethnic Georgian villages on the Russian side of the border, chasing false rumors that we’d heard from another Western correspondent that the Georgian inhabitants there had been attacked and cleansed. All we managed to do by going into those villages was to frighten the poor villagers. Later that day, Osborn and I went to makeshift Ossetian refugee centers to check out their claims of tens of thousands of refugees; their claims checked out.)

“We don’t want to be shown the same Tskhinvali ruins again and again,” Siegel complained. “We’ve already seen them, you know? You’re not giving us anything new.” A Brit correspondent from ITN—who, like all the TV correspondents, wore a bulletproof vest long after even their own cameramen stopped wearing them—suddenly perked up from his beer: “It’s a cover-up!” he shouted. “You’re trying to cover it up!”

The real problem was this: the editors at their desks in the home countries weren’t interested in Ossetian suffering; they wanted to exaggerate the Georgian suffering and vilify the Russians. To the second-stringers at that table, being shown the awful truth of Georgian culpability was equivalent to being handed a bunch of losing lottery tickets—because Georgian culpability and Ossetian grievances simply weren’t in demand back in New York and Washington. There was a real sense of professional anger and desperation at the table, and Sasha sensed it.

Surprisingly, the Kremlin tour organizer caved. The next day, Sasha arranged for the Western correspondents’ first tour into occupied Gori, traveling in from the Russian/Ossetian side rather than up from the Georgian side—this would provide fresh news. And he gave us much greater access to the ethnic Georgian villages behind Russian lines that had been torched in reprisal attacks following Georgia’s brutal invasion, which leveled buildings and villages and drove tens of thousands of Ossetian refugees into Russia. Sasha figured that it was a worthwhile trade-off: it was so important to show what he thought was the much bigger page-one story—that the Georgians lied when they claimed that Russia had bombed Gori into rubble—that it was worth conceding a story about how Ossetian and Chechen irregulars had torched Georgian homes in order to debunk the Gori-destruction propaganda that had been used so successfully to demonize Russia. Here is what Siegel’s trip to Gori contributed to the Times article, which made no mention of how Gori was indeed almost completely unscathed:

"A Times reporter traveling between Tskhinvali, which is the South Ossetian capital, and Gori saw extensive sections of [Georgian] villages that had been burned."

On the long ride down to Gori via South Ossetia, Siegel loudly and busily counted up the burned houses in ethnic Georgian villages, excitedly telling everyone, “This is what my New York Times editor wants,” running up and down the Hyundai minibus aisle. When

we'd pass through Ossetian villages, he was back in his seat, on the phone loudly reporting figures into his cellphone.

When we got to Gori, we saw that it wasn't bombed to the ground, as we'd expected. Frankly, I was shocked: after what the Russians did to Grozny during the two Chechen wars, I couldn't believe that they wouldn't bomb an enemy city into rubble first and ask questions later. But the fact was, compared with the ruins of Tskhinvali, Gori looked like Geneva. Siegel wasn't interested—or, rather, his Times editor wasn't—so he went running around looking for evidence that the Russians had dropped a cluster bomb. He thought he found that evidence—we all saw the bombshell—but apparently it wasn't rock-solid enough for the Times editors.

The production of the final article that appeared on page one, with Siegel's contribution from bean-counting the burning houses, was almost entirely Georgia-centric: while temp-stringer Siegel was hired to cover the Russian/Ossetian side of the conflict zone, staffers Sabrina Tavernise, C.J. Chivers and Michael Schwartz were stationed on the Georgian side, along with photographer-reporters Joao Silva and Justyna Mielnikiewicz, who has lived in Tblisi since 2001.

Had Siegel—or, rather, his editor—taken an interest in the really important story that we saw that day—that the Georgian propagandists had wildly exaggerated the destruction in Gori, which should have cast doubt on their entire story all along—the Times would not have had to wait until November 7 to “call into question” Georgia's claims. The paper could have called them into question right there—or at a hundred other opportunities that I saw in my time in the conflict zone.

Apparently, the editors weren't interested. And this is where the Times's reporting—from the editorial decision to base all of its staffers on the Georgian side while leaving the crucial Russian/Ossetian side of the battle zone to a stringer eager to please his US-based employer—went so woefully, recklessly wrong. In Siegel's defense, he didn't make the editorial decision to ignore the real Gori story. It seemed clear to me that it wasn't his decision, but rather that of his editors, to highlight the unbombed parts of Tskhinvali when he reported from there a few days earlier:

"Russian statements had likened the Georgian assault to other recent cataclysmic wars in the Caucasus, like the razing of Grozny in Chechnya. But while Tskhinvali sustained significant damage, it was not as widespread or catastrophic as the state-run Russian news media had portrayed it.

"Fighting appears to have been concentrated in two neighborhoods, while buildings in the rest of the city stood intact. Entire residential neighborhoods appeared unscathed. Even in the hardest-hit areas, most buildings were left standing."

I'm still shocked today reading this. Yes, most of the buildings were standing. It's hard to level buildings in just a few days of shelling and tank fire, no matter how fierce and indiscriminate. What the Times's stringer didn't include was that the “two neighborhoods” he alluded to were Tskhinvali's main residential district, nicknamed Shanghai because of its population density (it's where most of the city's high-rise apartment blocks are located), and the old Jewish Quarter, which was nothing but piles of rubble. Leaving out those powerful, significant details—and again, this looks like the fault of the editors in New York who hired Siegel—is active propaganda.

To see what I mean, here's how a more seasoned reporter, Peter Finn of the Washington Post, reported the same scene a couple of days later, when he finally was let into Tskhinvali:

"The war between Georgia and Russia was centered on this town of at most 10,000 people, and it cut a swath of destruction, severely damaging many homes and apartment buildings.

"The scale of the destruction is undeniable; some streets summon iconic images of Stalingrad during World War II or Grozny, the capital of Chechnya, which was leveled in

two wars between Russian and Chechen separatists."

What's more disturbing is how the Times stuck to its false narrative about an innocent Georgia attacked by a neo-imperialist Russia long after the war ended and evidence started to pour in of Georgia's culpability. It took whistleblowers, human rights organizations and the Western European media to reveal what happened. In mid-September, Germany's Der Spiegel published an investigative report drawing on interviews with OSCE monitors who witnessed the war, asking, in its subhead, "Did Saakashvili Lie?"

### **A Myth Disproved**

In late October, the BBC aired a documentary, What Really Happened in South Ossetia, that once and for all destroyed the neocon/mainstream American fairy tale about innocent, democratic Georgia: "The BBC has discovered evidence that Georgia may have committed war crimes in its attack on its breakaway region of South Ossetia in August," the documentary reported.

The BBC used the results of its investigation to confront Britain's foreign minister, David Miliband, with these new facts; Miliband conceded that Georgia's behavior was "reckless," and he vowed to confront its leadership with allegations that Georgia had deliberately targeted South Ossetian civilians with tanks and missiles.

But while the European media took its politicians to task over Georgia's culpability, John McCain and his neocon advisers were able to set the agenda and paint the war in South Ossetia in deliberately false and alarming terms, backed by the unquestioning American media, leaving Barack Obama's team with little choice but to fall in line with the "new cold war" fever or else risk looking like appeasers. Yet because of Team McCain's close ties to Saakashvili, and the recent unmistakable revelations about Georgia's guilt in launching the war, one investigative reporter, Gerald Posner, recently asked, "Did McCain Bury the Truth About Russia?"

Like so many other serious questions, it's unlikely that the major American media outlets will bother answering that question. Meanwhile, the evidence showing that Georgia was no less guilty than Russia of war crimes kept piling up: Human Rights Watch has been releasing reports condemning Georgia's wartime violations and crimes, including indiscriminate shelling of civilians and use of illegal weapons such as cluster bombs and rockets on civilian targets; Reporters Without Borders denounced Georgia's deteriorating press freedoms, ranking the country in the cellar with odious Third World dictatorships; and Amnesty International has issued a detailed study accusing Georgia of committing war crimes right alongside Russia, as reported in the Associated Press:

"Its sweeping 69-page report cites evidence suggesting that Georgian forces indiscriminately fired on civilian targets in Tskhinvali, the capital of the Russian-backed breakaway province of South Ossetia...and violated international law on the conduct of war."

In light of all this mounting evidence that there is no black-and-white good guy/bad guy reality to square with the dominant narrative, it was only a matter of time before someone in the major American media would get around to reporting the facts. And yet the Times clung to its narrative. On September 16, just as Der Spiegel published its exposé on Saakashvili's lies and culpability in launching the invasion and committing war crimes, the New York Times published a front-pager, "Georgia Offers Fresh Evidence on War's Start," which tried to prove yet again that Russia invaded first, unprovoked.

The evidence backing the story consisted of a cassette recording that Saakashvili's people handed to a Times reporter a month after the war.

Why didn't the Times question the tape? In the aforementioned BBC investigative documentary about South Ossetia, host Tim Whewell is shown listening to this same tape

with a Georgian Interior Ministry official, Shota Utiashvili. But instead of buying it hook, line and sinker, as the Times did, Whewell reacted skeptically: Whewell: "So even though this tape was so important as evidence of Russia's actions, you actually lost it for a month?" □ Utiashvili (looking embarrassed): "Well we, we hadn't, we never lost it actually because it was, it was in the files. But we had about 6,000 intercepts at the same time." □ Whewell: "So even one so important to your case, you didn't keep it specially, separately?" □ Utiashvili: "No, no. That was a mistake." □ Utiashvili's "the dog ate my homework" excuse for why Georgia released those tapes a month after the war made for a great television moment: the triumph of serious journalism over propaganda, the shaming of a government official caught in a bad lie. But for the BBC's counterparts at the New York Times, that same tape, unquestioned, offered the very opposite: a chance to shore up a crumbling fairy tale that the Times had sold to its trusting readership, even though the consequence of shoring up that fairy tale was a cold war nightmare.

## No Apologies

Now that even the Times has reversed itself, the question is: will it do the responsible thing and apologize to its readers for its journalistic malpractice? After all, the consequences of its slanted reporting helped shape a political supra-reality that pushed us to the brink of a new cold war. Will America's paper of record issue an apology, however feeble, as it did for the Iraq debacle? Will anyone be held accountable?

In May 2004, in the wake of its reporting on the lead-up to the Iraq War, the Times published a feeble mea culpa, "The Times and Iraq," in which the editors sought to expose their failures: "Editors at several levels who should have been challenging reporters and pressing for more skepticism were perhaps too intent on rushing scoops into the paper. . . . □ "We consider the story of Iraq's weapons, and of the pattern of misinformation, to be unfinished business. And we fully intend to continue aggressive reporting aimed at setting the record straight."

Just four years later, the Times repeated those same mistakes in South Ossetia. The paper doesn't seem to have learned from its journalistic malpractice debacle over Iraq. It promised its readers, and the public at large, that it would try never to make that mistake again. How many more mistakes will it take before the Times delivers on its promises? I essentially posed this question to the Times when I asked the paper to comment on this critique of its war coverage. I received a lengthy response from Craig Whitney, standards editor for the Times and a former correspondent in the Soviet Union from 1977 to 1980. It began by accusing me of "a perverse distortion of this reporting, nothing less, to say that [the Times] portrayed Georgia as a victim of Russian aggression rather than as an aggressor." There followed twenty-three pages of article excerpts spanning the last six months or so—revealing a record not of the Times getting the story right about Georgia's guilt in launching the war but rather one of bet-hedging for journalists, just enough qualifiers slipped into the articles to indemnify the Times from criticism should the conventional wisdom on that war change.

"What we can do, and did, was try our best to sort it out after the shooting started," Whitney stated. He may believe that—but if he does, it only points to how profoundly unaware major media players can be. Since I was there, I know how the Times created its false slant in this war, misleading its readers and helping create the grounds for a new cold war. It leaves me wondering how many other major stories the Times has been blowing this badly.

On December 3, the Times's lead editorial about Iraq asked for, in the words of its headline, "At Least Some Accountability". It's ironic that what the New York Times rightly asks of others it fails to deliver itself.

## Appendix IV – Analysis of Western Misreporting of the Georgian War, by Prof. Gordon Hahn

*Professor Hahn's incisive analysis of Western press coverage of Russia, available on [www.russiaotherpointsofview.com](http://www.russiaotherpointsofview.com), provides a scholarly and dispassionate analysis beyond anything T&B could hope to produce. Issued contemporaneously with the conflict, it demonstrates just how transparent was the manipulation of information, from the beginning.*

### [Georgia's Misinformation War](#)

by Gordon Hahn

The five-day Georgian-Russian war saw Georgian President Mikheil Saakashvili and other Georgian officials waging an aggressive propaganda campaign and, in many ways, a disinformation war in the Western mass media. This media offensive was the result either of a carefully planned disinformation war or a rush by Western governments, mainstream media, and think tanks to get the Georgians' side of the story and their side only. Either way, the Georgians were able to wage an effective and constant barrage of propaganda and disinformation against the Russians. In some 40 appearances in the Western media and at Western think tanks, Georgian President Mikheil Saakashvili and his ministers made numerous statements in their effort to convince the West that it was obliged to defend Tbilisi from Russia's incursion. The following is a review of Georgia's official version of events and a comparison of their claims with the facts as we know them as of late August and early September 2008.

#### **RUSSIAN PLANNED WAR AND ATTACKED FIRST**

**CLAIM:** President Saakashvili and other Georgian officials repeatedly accused Russia of undertaking a "well-planned invasion" of Georgia and attacked first in order to seize the country and remove him from power. [Mikheil Saakashvili, "Russia's War Is The West's Challenge," Washington Post, August 14, 2008 and CNN interview with Georgian President Mikheil Saakashvili, CNN News, 8 August 2008, [www.cnn.com/video/#/video/world/2008/08/08/intv.saakashvili.cnn?iref=videosearch](http://www.cnn.com/video/#/video/world/2008/08/08/intv.saakashvili.cnn?iref=videosearch).]

**FACT:** Both sides planned for war as a contingency. They both held maneuvers in late July, used them to move forces and equipment near (Russian) or into (Georgian) the conflict zone, and ratcheted up the confrontation from the usual summertime tit-for-tat sniper and small arms fire to mortars to light and then heavy artillery until approximately midnight August 7-8 when Georgian forces opened up a massive heavy artillery barrage and sent at least two battalions into South Ossetia's capitol of Tskhinvali. Russian forces were ready and responded with a full-scale invasion and air war.

Georgian military officials have inadvertently revealed that they had brought heavy artillery into the conflict zone very early on. For instance artillery brigade commanders told a Georgian newspaper that Georgian artillery used in the zone on August 7 included: "(a)t least 300 gun barrels of Georgian artillery." Among these were: "the 203-mm Pion systems, the 160-mm Israeli-made GRADLAR multiple rocket launchers, the 152-mm Akatsiya, Giatsint and Dana self-propelled guns, the 122-mm Grad and RM-70 multiple rocket launchers, as well as the D-30 and Msta howitzers of the infantry brigades." ["Georgian artillery inflicted 'heavy losses' on Russians," BBC Monitoring, August 25, 2008 translating Georgian weekly Kviris Palitra, August 25, 2008.] It takes many days if not weeks to bring in the kind of heavy artillery about which the commander is talking into or near the conflict zone through the mountainous terrain around South Ossetia from Georgian army bases in Tbilisi, Senaki or Gori.

## **THE RUSSIANS BROKE SAAKASHVILI'S AUGUST 7 CEASEFIRE**

**CLAIM:** Saakashvili claims the Russians broke his late afternoon August 7 ceasefire.

**FACT:** In fact, no cessation of fire occurred; both sides continued with more sporadic fire. Moreover, as Saakashvili was declaring his ceasefire, Georgia began moving reinforcements to the conflict zone to back up the two battalions and materiel they had already positioned there in violation of the ceasefire agreement. [Peter Finn "A Two-Sided Descent into Full-Scale War," The Washington Post, August 17, 2008, p. A1.]

## **GEORGIAN FORCES OCCUPIED ALMOST ALL OF SOUTH OSSETIA**

**CLAIM:** As Russian and Ossetian forces engaged the Georgian army on August 8, Saakashvili claimed: "The Georgian government's forces, according to information as of 21:00, completely control the entire territory of South Ossetia except the highland settlements of Dzhava."

[“Saakashvili: voiska Gruzii kontroliruet vsyu territoriyu Yuzhnoi Ossetii,” KavkazMemo.ru, 8 August 2008, [www.kavkaz-uzel.ru/printnews/news/id/1226844.html](http://www.kavkaz-uzel.ru/printnews/news/id/1226844.html).]

**FACT:** In fact, Georgian troops never even controlled all of Tskhinvali and began withdrawing from there at 20:30 and only held a slice of the city in the south as Russian troops began to enter it. [Timeline from the Georgian Foreign Ministry, accessed 28 August 2008, [www.mfa.gov.ge/index.php?lang\\_id=ENG&sec\\_id=461&info\\_id=7484p](http://www.mfa.gov.ge/index.php?lang_id=ENG&sec_id=461&info_id=7484p)]

## **CONTACTS WITH RUSSIAN AUTHORITIES**

**CLAIM:** In his August 14 Washington Post article, Saakashvili stated: "Our repeated attempts to contact senior Russian leaders were rebuffed. Russia's foreign ministry even denied receiving our notice of cease-fire hours after it was officially -- and very publicly -- delivered. This was just one of many cynical ploys to deceive the world and justify further attacks." [Saakashvili, "Russia's War Is The West's Challenge"] The Georgian president was reiterating a claim he made in his televised address to the Georgian people on August 7, when he Saakashvili stated that the Georgian authorities had not been in touch with Vladimir Putin or other Russian authorities "for days." [CNN interview with Georgian President Mikheil Saakashvili, CNN News, 8 August 2008, [www.cnn.com/video/#/video/world/2008/08/08/intv.saakashvili.cnn?iref=videosearch](http://www.cnn.com/video/#/video/world/2008/08/08/intv.saakashvili.cnn?iref=videosearch).]

**FACT:** On the next day in his television address to the Georgian people Saakashvili said: "We have been in constant contact with the leadership of the local Russian peacekeeping forces. Several hours ago, they told us that they have completely lost control over the actions of the separatists.... We are in constant contact with the leadership of the Russian Ministry of Foreign Affairs, and the ministry tells us Russia is trying to stop the separatists from engaging in armed action, but without any success." ["Saakashvili's Televised Address on S. Ossetia," Civil Georgia, 7 August 2008, 21:45, [www.civil.ge](http://www.civil.ge).]

## **HOW MANY RUSSIAN TANKS AND ARMoured VEHICLES?**

**CLAIM:** At an August 18 Heritage Foundation conference 'The Russia-Georgian War: A Challenge to the U.S. and the World' Georgian Ambassador to the US, Vasil Sikharulidze, stated that "1,200 tanks and 15,000 soldiers" entered Georgia "within 12 hours" bringing the number of Russian troops in all of Georgia to 25,000 as of August 18. Georgian Minister for Reintegration of Abkhazia and South Ossetia Temuri Yakobashvili told the conference by video phone that 1,200 tanks and armored personnel carriers entered Georgia in the first 48 hours of the Russian incursion. [Transcript of a Heritage Foundation Forum on the Russian-Georgian War "A Challenge for the U.S. and the World," Heritage Foundation, Washington DC, August 18, 2008, Federal News Service, August 18, 2008.] Three weeks after the war Yakobashvili also escalated

his figures to “2,000 tanks.” [Nikolaus von Twickel, “Theories Swirl About War's Beginning,” The Moscow Times, August 28, 2008.]

**FACT:** No independent source has confirmed the deployment of such a large Russian invasion force. The respected Janes' Defence Weekly reported that in fact the “invasion force consisted of 15,000 and 150 tanks and heavy self-propelled artillery pieces.” [Giragosian, “Georgian planning flaws led to campaign failure.”]

#### **RUSSIA'S 3,000 ARMORED VEHICLES AND 80,000 TROOPS**

**CLAIM:** On August 24, Saakashvili claimed that the Russian military operation “planned for many months” brought “80,000 servicemen and mercenaries” and “about 3,000 armored vehicles” into Georgia. [“President says 80,000 Russian soldiers, 3,000 armored vehicles invaded Georgia,” BBC Monitoring, August 24, 2008 citing Channel 1, Tbilisi, August 24, 2008, 1600 GMT.]

**FACT:** Such a deployment of equipment would mean that Russia's entire 58th Army (and then some) was deployed from its jihad-plagued North Caucasus to South Ossetia. No other source has made such a claim.

#### **RUSSIAN ATROCITIES**

**CLAIM:** In his August 18 Washington Post article, Saakashvili wrote: “Within 24 hours of Russian forces of “brutally purging Georgian villages in South Ossetia, raping women and executing men.” [Saakashvili, “Russia's War Is The West's Challenge”] On the same day as well, Saakashvili stated in a CNN interview that Russian planes were “specifically targeting the civilian population, and we have scores of wounded and dead among the civilian population all around the country, not so much in the conflict area.” [CNN interview with Georgian President Mikheil Saakashvili, CNN News, 8 August 2008,

[www.cnn.com/video/#/video/world/2008/08/08/intv.saakashvili.cnn?iref=videosearch](http://www.cnn.com/video/#/video/world/2008/08/08/intv.saakashvili.cnn?iref=videosearch).] At an August 12 press conference, Saakashvili asserted that despite a ceasefire the Russians were continuing to attack “purely civilian targets.” [“Georgian Will Never Surrender,” CNN News, 12 August 2008,

[www.cnn.com/video/#/video/world/2008/08/12/sot.georgia.saakashvili.surrender.itn?iref=videosearch](http://www.cnn.com/video/#/video/world/2008/08/12/sot.georgia.saakashvili.surrender.itn?iref=videosearch).]

In an August 13 press conference, Saakashvili stated: “Russian tanks are attacking the town of Gori and rampaging through the town... The worst kind of marauding I ever could imagine. There was a rampage through Georgian-controlled villages of South Ossetia and through upper Abkhazia – Kodori, and scores of people, according to the reports which we cannot totally confirm... Internment camps were set up, and we are getting reports of large-scale violation of human rights of the worst case... What we are seeing in the area is classical Balkan-type and World war II-type ethnic cleansing and purification campaigns. ... (T)he worst kind of atrocities are being committed in my country against my people of all ethnic groups.” [“Tensions Still High in Georgia,” CNN News, 13 August 2008,

[www.cnn.com/video/#/video/world/2008/08/13/sot.georgia.presser.saakashvili.ap?iref=videosearch](http://www.cnn.com/video/#/video/world/2008/08/13/sot.georgia.presser.saakashvili.ap?iref=videosearch).]

Minister Yakobashvili told the Heritage Foundation that Russian forces had engaged in “ethnic cleansing” and inflicted “enormous atrocities, unbelievable suffering” on the Georgian population. [Transcript of a Heritage Foundation Forum on the Russian-Georgian War “A Challenge for the U.S. and the World,” Heritage Foundation, Washington DC, August 18, 2008, Federal News Service, August 18, 2008.]

**FACT:** As of two weeks after hostilities ended no campaign of ethnic cleansing or atrocities and no internment camps have been found. There have been no reports of Russians “raping women and executing men,” as Saakashvili claimed. There were later reports of destruction and perhaps a few murders committed by Chechen battalions (irresponsibly sent by Moscow to fight on its

behalf) and Ossetian militiamen. The alleged large scale killing, raping and internment camps have not been mentioned again by Saakashvili or any other Georgian official. Human Rights Watch has reported one occasion on which Russian air forces appear to have used of cluster bombs, banned by international convention. The Georgian side has stated a official civilian death toll among Georgians of 69 as of August 25 with several hundred civilians wounded. [“Senior MP: 215 Killed in Conflict,” Civil.ge, 19 August 2008, 23:05

[www.civil.ge/eng/article.php?id=19215&search=civilians%20killed](http://www.civil.ge/eng/article.php?id=19215&search=civilians%20killed)] This hardly amounts to the massive Russian atrocities being claimed by Tbilisi. Also, there are reports of rather good behavior on the part of Russian soldiers. [See Saba Tsitsikhashvili, “The Ramifications of the Ten-Day Blockade of Georgia,” HumanRights.ge, 27 August 2008, [www.humanrights.ge/index.php?a=article&id=3057&lang=en](http://www.humanrights.ge/index.php?a=article&id=3057&lang=en).] As the respected military studies journal Janes’ Defence Weekly reported on August 15, it was the Georgian army that targeted the residential capitol of South Ossetia with an indiscriminate, all night artillery barrage on 7-8 August with “notoriously imprecise” truck-borne GRAD missiles. [Richard Giragosian, “Georgian planning flaws led to campaign failure,” Janes’ Defence Weekly, August 15, 2008 in Johnson’s Russia List, #152, August 19, 2008, [www.cdi.org/russia/johnsonwww.org](http://www.cdi.org/russia/johnsonwww.org)]

#### **THE RUSSIANS, NOT THE GEORGIANS DESTROYED TSKHINVALI**

**CLAIM:** On August 13, Saakashvili told a press conference that Russian aerial bombardment, not Georgian artillery fire, “leveled the town of Tskhinvali.” [“Tensions Still High in Georgia,” CNN News, 13 August 2008,

[www.cnn.com/video/#/video/world/2008/08/13/sot.georgia.presser.saakashvili.ap?iref=videosearch.](http://www.cnn.com/video/#/video/world/2008/08/13/sot.georgia.presser.saakashvili.ap?iref=videosearch.)]

**FACT:** Every independent source reports that Georgian artillery bombarded Tskhinvali for twelve hours through the night of August 7-8. Saakashvili is the only person to claim that Georgia did not bomb Tskhinvali and that the Russians caused all or most of the damage.

#### **RUSSIAN DESTRUCTION OF GEORGIAN CIVILIAN INFRASTRUCTURE**

**CLAIM:** Saakashvili, as we have seen, accused Russia of destroying civilian infrastructure. His underlings, Ambassador Sikhuralidze and Minister Yakobashvili ministers told the West that Russian forces were systematically destroying Georgia’s civilian infrastructure, including burning its forests and national parks and blowing up bridges to sever Georgia from its neighbors, Armenia and Azerbaijan. [Transcript of a Heritage Foundation Forum on the Russian-Georgian War.]

**FACT:** Reporters on the scene have reported a very different story: “In west Georgia, few signs of damage by Russia” shows, the Russians in fact “used force minimally” and “avoided any inadvertent high-profile attacks on civilian targets.” “Early in the conflict, Georgian officials in Tbilisi warned of an impending disaster as Russian tanks from Abkhazia massed at Zugdidi’s edge. But residents said there had been little or no damage to their town.” Even Russia’s air attacks on the port of Poti destroyed the military side of the port but left the civilian side intact. [Borzou Daraghi, “In west Georgia, few signs of damage by Russia,” Los Angeles Times, August 19, 2008.] Regarding the torching of Georgian forests, a Georgian newspaper noted that the Russian military set fire to forests during the occupation of Kartli because it was searching for Georgian artillery weapons that Georgian artillerymen hid there during the Georgian army’s retreat; a fact left out Minister Yakobashvili’s comments. At least two major bridges were destroyed by Georgian forces in targeting Russians making crossings. [“Georgian artillery inflicted 'heavy losses' on Russians,” BBC Monitoring, August 25, 2008 translating Georgian weekly Kviris Palitra, August 25, 2008; Roman Anin, “Kto v sopagakh – tot i srochnik. Ikh zdes’ polno,” Novaya gazeta, No. 62, 25 August 2008.]

### **RUSSIAN TROOPS ENCIRCLING TBILISI**

**CLAIM:** On Wednesday, August 13, Saakashvili said in a CNN interview that Russian troops were “circling,” “closing on” and planning to capture the Georgian capitol, Tbilisi, and install a puppet government. [See Misha Dzhindzhikhashvili, “Georgian president's Russia claims raise eyebrows,” Associated Press, 13 August 2008, 8:12.]

**FACT:** The Russians undertook no military operations against the Georgian capitol throughout the five-day war.

### **RUSSIA WILL BOMB TBILISI DEMONSTRATION**

**CLAIM:** On August 12 Saakashvili mentioned and therefore gave credence to supposed rumors that Russia would bomb the August 12 rally in Tbilisi. [Dzhindzhikhashvili, “Georgian president's Russia claims raise eyebrows.”]

**FACT:** There was no Russian bombing of Tbilisi throughout the war.

### **RUSSIA BOMBING THE BAKU-TBILISI-CEYHAN OIL PIPELINE**

**CLAIM:** Minister Yakobashvili tried to pique American fears that Russian forces sought to interdict the Baku-Tbilisi-Ceyhan oil pipeline by saying that the Russians had repeatedly tried to bomb it. [Transcript of a Heritage Foundation Forum on the Russian-Georgian War.]

**FACT:** A Russian force that included tens of sophisticated fighter jets and, according to the Georgians’ own statements, some 1,200-3,000 tanks and armored personnel carriers would have been able to bomb a pipeline and much else in the course of five days if it had wanted to.

### **CYBER WAR**

**CLAIM:** Minister Yakobashvili and other Georgian officials claimed that Russian authorities initiated a large-scale cyber-attack on Georgian government websites before and during the war. [Transcript of a Heritage Foundation Forum on the Russian-Georgian War.]

**FACT:** Experts on cyber warfare have grave doubts that the Russian military or intelligence agencies conducted cyber warfare against Georgia. They argue that the suspected attacks were consistent with independent hacker networks that hit Georgian pornography and gambling website as part of an extortion racket. Moreover, these attacks were only launched after Georgian forces had already engaged Russia forces, suggesting that they were either attacks by independents or that the Russians were not ready for war, since cyber warfare is a part of the Russian arsenal. [Shaun Waterman, “Analysis: Russia-Georgia cyber war doubted,” United Press International, August 18, 2008.] On August 5 Georgian hackers targeted SOTR (South Ossetia Television and Radio) after it reported that Tbilisi was covering up the killing of 29 Georgian servicemen during an exchange of fire between Ossetian and Georgian forces on August 1-2. [Osetinskie saity atakovany khakerami posle publikatsii o tainykh pokhoronakh gruzinskikh soldat,” Regnum.ru, 5 August 2008, [www.regnum.ru-news/1036460.html](http://www.regnum.ru-news/1036460.html).]

### **U.S. IS TAKING OVER GEORGIA’S PORT AND AIRPORTS**

**CLAIM:** On August 10 Saakashvili claimed on Georgian national television that the arrival of U.S. military cargo plane carrying humanitarian aid meant that “Georgia's ports and airports will be taken under the control of the U.S. Defense Department.” [Dzhindzhikhashvili, “Georgian president's Russia claims raise eyebrows.”]

**FACT:** The U.S. Defense Department Pentagon spokesman Geoff Morrell immediately refuted this: “We have no need, nor do we intend to take over any Georgian air or seaport to deliver humanitarian aid. ... We have no designs on taking control of any Georgian facility.”

[Dzhindzhikhashvili, “Georgian president's Russia claims raise eyebrows.”]The U.S. never did so.

#### **RUSSIA HAS LOST MORE PLANES THAN IN ANY CONFLICT IN ITS HISTORY**

**CLAIM:** In an August 13 television address Saakashvili said, “Russia has lost more airplanes than in any conflict of this scale since 1939.” [Dzhindzhikhashvili, “Georgian president's Russia claims raise eyebrows.”]

**FACT:** The entire Soviet air force was destroyed in the first days of Hitler’s invasion of the USSR, and in the present war Russia is claiming the loss of four airplanes.

#### **CONCLUSION**

American support for Georgia in the present crisis is based in part on the belief that Russia is to be blame for instigating this war. Much of this belief is founded on Saakashvili’s and other Georgian officials’ statements to American officials like the State Department’s Matthew Bryza. Western publics and decision makers should not take the statements of Georgian officials regarding this war, or much of anything else, at face value. They should think twice, and then thrice, about whether backing President Saakashvili, his aspirations for Georgian membership in NATO, and whether the resulting ‘hot peace’ with Moscow are in the West’s interests.

Dr. Gordon M. Hahn - Senior Researcher, Monterey Terrorism Research and Education Program and Visiting Assistant Professor, Graduate School of International Policy Studies, Monterey Institute of International Studies, Monterey, California; Senior Researcher, Center for Terrorism and Intelligence Studies (CETIS), Akribis Group; and Analyst/Consultant, Russia Other Points of View – Russia Media Watch, [www.russiaotherpointsofview.com](http://www.russiaotherpointsofview.com). Dr Hahn is author of two well-received books, *Russia’s Islamic Threat* (Yale University Press, 2007) and *Russia’s Revolution From Above* (Transaction, 2002), and numerous articles on Russian politics.

## Appendix V – Martin Wolfe column from the FT

*Especially when discussing matters unrelated to Russia, the FT can occasionally still live up to its reputation*

### **The Urgent Task is to return the World Economy to Health**

The shorter-term challenge is to sustain aggregate demand, as Keynes would have recommended. Also important will be direct central-bank finance of borrowers. It is evident that much of the load will fall on the US, largely because the Europeans, Japanese and even the Chinese are too inert, too complacent, or too weak. Given the correction of household spending under way in the deficit countries, this period of high government spending is, alas, likely to last for years. At the same time, a big effort must be made to purge the balance sheets of households and the financial system. A debt-for-equity swap is surely going to be necessary.

The longer-term challenge is to force a rebalancing of global demand. Deficit countries cannot be expected to spend their way into bankruptcy, while surplus countries condemn as profligacy the spending from which their exporters benefit so much. In the necessary attempt to reconstruct the global economic order, on which the new administration must focus, this will be a central issue. It is one Keynes himself had in mind when he put forward his ideas for the postwar monetary system at the Bretton Woods conference in 1944.

No less pragmatic must be the attempt to construct a new system of global financial regulation and an approach to monetary policy that curbs credit booms and asset bubbles. As Minsky made clear, no permanent answer exists. But recognition of the systemic frailty of a complex financial system would be a good start.

As was the case in the 1930s, we also have a choice: it is to deal with these challenges cooperatively and pragmatically or let ideological blinkers and selfishness obstruct us. The objective is also clear: to preserve an open and at least reasonably stable world economy that offers opportunity to as much of humanity as possible. We have done a disturbingly poor job of this in recent years. We must do better. We can do so, provided we approach the task in a spirit of humility and pragmatism, shorn of ideological blinkers

As Oscar Wilde might have said, in economics, the truth is rarely pure and never simple. That is, for me, the biggest lesson of this crisis. It is also the one Keynes himself still teaches.

[martin.wolf@ft.com](mailto:martin.wolf@ft.com)

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***Like cats and horses, markets – whether emerging or emerged, are apt to do as they damned-well choose, and a considerable measure of luck is required to come out in one piece. Exercise caution in all things. Good Luck!***

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