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Anton Troianovski

To avoid sanctions, Kremlin goes off the grid

How a breakaway region near the Black Sea is helping Russia support rebels in eastern Ukraine.

*Щоб уникнути санкцій, Кремль відключається від мережі
Як відокремлений регіон поблизу Чорного моря допомагає Росії
підтримувати повстанців у Східній Україні*

Завдяки Південній Осетії Москві не доводиться формально визнавати незалежність так званих «ДНР» і «ЛНР», щоб російські банки могли працювати з бойовиками напрямку. А крім того, це дозволяє обійти західні санкції, адже операції фактично відбуваються в межах російської фінансової системи. Видання підкреслює, що Росія надає своїм силам на Сході України і більш пряму допомогу. Вона відсилає зброю і військових, а також цілі так звані «гуманітарні конвої» на українську територію. Але південно-осетинська схема вказує на існування і більш формалізованого фінансового зв'язку, який дозволяє людям на окупованих територіях торгувати із зовнішнім світом. Журналісти Washington Post, які побували в Південній Осетії, змогли провести низку інтерв'ю з місцевими ватажками і бачили документи сепаратистського регіону. Все вказує на те, що анклав поступово перетворився на фінансову опору Москви.

https://www.washingtonpost.com/news/world/wp/2018/11/21/feature/how-russia-avoids-sanctions-and-supports-rebels-in-eastern-ukraine-using-a-financial-system/?utm_term=.06991e66dddc

An isolated, war-scarred enclave in the Caucasus Mountains has become a hidden financial crossroads for Russia's shadow empire around the Black Sea.

The Kremlin has for years bankrolled an array of pro-Russian breakaway states within the former Soviet republics of Ukraine, Georgia and Moldova. For Moscow, the goals could not be bigger — rebuilding Russia's influence and countering the region's drift toward the West.

The network of semi-states has become so important for Russia that an off-the-grid financial system now ties some of them together, bridging hundreds of miles and circumventing international sanctions.

A Washington Post investigation — including interviews with business and political leaders — uncovered the extensive use of this improvised banking system, which runs through a mountainous patch called South Ossetia, a self-declared splinter state in Georgia.

It works like a relay around the barriers put up by sanctions imposed by the European Union, the United States and others spelling out penalties for doing business directly with the separatist territories.

Separatist officials and business figures in eastern Ukraine — one of the main Moscow-backed breakaway territories in the region — transfer money to South Ossetia. The funds are wired to Russia, officials familiar with the arrangement told The Post. The money then pays for goods such as fuel and building materials, which are shipped from Russia directly to eastern Ukraine, interviews and records show.

The arrangement also works in reverse, allowing exports from the separatist territories to be sold in Russia. This year alone, more than \$150 million in payments has been funneled through South Ossetia, according to an estimate by the territory's tax office.

The South Ossetian tax office provided The Post with a list of 146 newly registered companies likely to be doing business with separatist eastern Ukraine. The biggest taxpayer among them appears to be the Republican Fuel Co., a network of 52 gas stations owned by the rebel government of the self-proclaimed Donetsk People's Republic. Its roughly \$80,000 tax bill for the first seven months of 2018 suggests the company imported fuel from Russia and paid for it via South Ossetia. The Republican Fuel Co. declined to comment.

In a rare visit by a Western journalist to South Ossetia, The Post reviewed documents and conducted interviews that showed how the enclave has quietly become a financial linchpin for Moscow.

"Maybe, from someone else's point of view, this is wrong," said Vakhtang Dzhigkaev, deputy head of the South Ossetian Chamber of Trade and Industry. "But from our point of view, we're operating in the realm of legality."

The story of how a Caucasus backwater became a Kremlin financial hub sheds light on Russia's opportunistic, low-budget approach to building its foreign influence in the region.

On a practical level, South Ossetia has allowed Russia to create its own rules and discrete financial channels to help sustain separatist economies and sidestep sanctions. The main beneficiary has been the separatists in eastern Ukraine — the most active flash point around the Black Sea.

South Ossetia also serves as a key Russian foothold to project staying power. For Russian President Vladimir Putin, the Black Sea region is among the main arenas as Moscow challenges what it views as Western encroachment.

Some of the Western-looking governments in the region — including Georgia, Ukraine and Moldova — have deepened cooperation with NATO and hold aspirations of possible formal membership in the future.

"Unresolved conflicts are clearly instruments of trying to keep these countries in the Russian orbit," said Ketevan Tsikhelashvili, the Georgian government minister in charge of conflict resolution with her country's breakaway territories.

With a gross domestic product less than one-tenth of the United States, Russia struggles to compete with the West economically even as Moscow's huge nuclear arsenal and costly military expansion remain key elements of its global ambitions. That economic mismatch means that Western sanctions can have an impact — and forces Russia to be both frugal and creative in trying to work around them.

Site of two wars

Conflict-battered South Ossetia also has become an improbable financial gateway over the past three years.

About the size of Rhode Island, it has been the site of two wars between Western-leaning Georgia and Moscow-backed forces since the 1990s. Reminders of combat — toppled buildings and walls pockmarked by gunfire — rest among orchards, springs and mountain valleys. The population of roughly 50,000 largely speaks the native Ossetian tongue and maintains its traditions of homemade wine and salty cheese.

The Kremlin-backed rebel territories in eastern Ukraine — the self-proclaimed Donetsk and Luhansk people's republics — are 400 miles to the northwest. And the battles there have no direct impact on life in South Ossetia.

Still, South Ossetia is a vital cog for Moscow's reach into the Black Sea region.

The enclave's murky international status gives Russia free rein to set up its own banking system outside the normal rules. While South Ossetia describes itself as independent, it relies on Russia for its security and for almost all of its budget revenue. Georgian officials say that no major decisions are made in the territory without Moscow's approval.

The separate banking system, in turn, serves as a way to sustain the separatist eastern-Ukrainian economy as the war grinds on. More than 10,000 people have died in that conflict since 2014, according to the United Nations. Sporadic fighting continues between the rebels and Ukrainian forces.

The financial threads between the Kremlin and Ukraine's separatists pass through a sleek office building on Stalin Street in Tskhinvali, the main city of South Ossetia.

There, a three-year-old institution called the International Settlements Bank handles financial transactions with separatist territories in eastern Ukraine.

Russia traded roughly more than \$150 million in goods with rebel-held territory in Ukraine in the first half of this year using South Ossetia as the payment center, according to officials and tax records. At least 146 limited liability companies, the South Ossetian tax office said, were active this year in facilitating trade with the Russian-backed separatist territories.

"Ossetia is essentially like an offshore company," said a lawyer based in the eastern-Ukraine rebel stronghold of Donetsk who specializes in foreign trade. He spoke on the condition of anonymity because he said he worried about repercussions for describing the system to a Western reporter.

"This scheme," he said, "was clearly thought up by some rather sophisticated people."

Financial 'triangle'

The arrangement — which lawyers, businesspeople and officials described to The Post, many also speaking on the condition of anonymity — works like a "triangle," according to an adviser to separatist leaders in the Donetsk region.

Step 1:

Anytime someone in separatist territories wants to wire money to a company in Russia — and beyond — they do so by way of the International Settlements Bank in South Ossetia. (South Ossetia is the only entity that recognizes the eastern-Ukraine breakaway regions, making it the only place to have a formal banking relationship with them.)

Step 2:

The money is sent onward to Russia. (Russia recognized South Ossetian independence after the 2008 war. That allows Russian banks to transfer money to and from South Ossetia.)

Step 3:

The goods paid for by the transfers — including fuel, building materials and food — are shipped to eastern Ukraine, largely by truck from Russia over a shared border. (Rerouting cash and trade through South Ossetia lets Russia avoid the Western sanctions and opprobrium it would incur were Moscow to officially recognize Ukraine's separatist republics.)

To be sure, Russia sends other aid to the separatists more directly. International monitors' surveillance drones in recent months have repeatedly sighted truck convoys traveling at night from Russia into separatist territory and avoiding official border crossings.

Western and Ukrainian officials say Russia provides the rebels with troops and military and logistical aid. Russia denies providing any direct military support.

The South Ossetian connection provides a more formalized financial link that allows the roughly 3 million people living in the separatist-occupied territories to trade with the outside world.

The framework of the system goes back to 2015.

That year, the International Settlements Bank opened on Tskhinvali's Stalin Street. In Moscow, meanwhile, another financial institution was formed at almost the same time with almost the same name — the Center for International Settlements. It got a banking license in 2016.

And its chairman, Vyacheslav Mazurin, is a 1981 graduate from the Higher School of the KGB — an elite training ground for Russian spies. Mazurin declined an interview request made through a spokeswoman.

Officially, the two institutions have nothing to do with each other. Both banks rejected interview requests. CMRBank, as the Moscow institution is now called, said in a brief statement that it “carries out its activities in strict accordance with the laws of the Russian Federation.”

But lawyers, businesspeople and government officials said that they form the backbone of the sanctions-snubbing financial nexus between Moscow and eastern Ukraine.

“We can only trade through South Ossetia — and we trade successfully,” said Zakhar Prilepin, a nationalist Russian writer who served as an adviser to the separatist Donetsk People’s Republic government until earlier this year. “They sign contracts with Ossetia, Ossetia does with us, and you get this triangle.”

A Moscow military outpost

South Ossetia also gives the Kremlin something else — a military outpost deep in the Caucasus region that was once part of the Soviet Union.

After hostilities between Georgia and South Ossetia erupted into war for a second time in 2008, the Russian military stepped in and invaded Georgia proper. Moscow now recognizes the independence of South Ossetia and another breakaway Georgian region, Abkhazia, and strengthened its military presence there.

Russia’s strategic map of the region includes other splinter territories: Transnistria in Moldova, on the western end of the Black Sea, as well as the Black Sea peninsula of Crimea, which Russia annexed from Ukraine in 2014 in a move that brought international outcry and sanctions against Moscow.

But the Kremlin’s commitment to separatism as statecraft is expensive.

Russia’s treasury is sapped by sanctions, an aging population, global military ambition and endemic corruption.

Of South Ossetia’s \$120 million in budget revenue last year, \$110 million came as aid from Russia, according to official records. A new bridge connecting annexed Crimea to Russia cost some \$4 billion. And Russia’s military intervention in eastern Ukraine, along with spending on welfare payments and other assistance to separatist-controlled territory, also amounts in the billions, according to Russian media reports and Ukrainian government estimates.

Remnants of war

A green fence, with cameras and motion sensors, runs through abandoned orchards separating South Ossetia from Georgia proper.

The road that once connected Georgia’s capital, Tbilisi, to Tskhinvali is blocked by barricades and machine-gun nests. On either side, memorials featuring charred remnants of warfare depict the other as the barbaric aggressor. In South Ossetia, there are the remains of burned cars. On the Georgian side, glass bottles melted from the heat of fires.

For South Ossetians, the winding drive and two-mile tunnel through the Caucasus to Russia is now the sole link to the rest of the world. There is no airport. Credit cards do not work. Imports are so sparse that printed books are a prized commodity.

“Ossetia United — with Russia and with Putin,” say letters scrawled in white paint on the road north from Tskhinvali.

Every Saturday morning, Dzerassa Dzhegayeva and three friends wend their way up a steep, dirt path before dawn, hauling a thermos of coffee and a bag of chocolates. They do exercises next to the ruins of a hilltop restaurant destroyed in South Ossetia’s first post-Soviet war in the 1990s. The second conflict, in 2008, killed Dzhegayeva’s brother and father.

“No matter what, we always hoped for something better,” said Dzhegayeva, a 47-year-old civil servant. She described the people of eastern Ukraine as brethren of sorts: “They are also being bombed. They are also in a situation with no way out.”

‘We’re scared’

Anatoly Bibilov, the president of the separatist government in South Ossetia, keeps a white bust of Putin and a statuette of the Russian president riding a bear on his desk. The memorabilia, he said, was given to him as gifts in eastern Ukraine.

The breakaway territories of eastern Ukraine, Bibilov said, “are in the exact same state that we South Ossetians were in 20 years ago. We remember perfectly well how much we wanted someone to support us.”

Russian-language outlets such as Meduza and Kommersant have also reported on South Ossetia’s role in trade with eastern Ukraine, but the sheer volume of the funds now flowing between the enclaves has not been previously documented.

The South Ossetian tax office gave The Post a list of 146 registered South Ossetian companies likely to be doing business with separatist eastern Ukraine. The list indicates that fuel, food and building materials exported from Russia into eastern Ukraine represented much of the flow of goods.

The tax office compiled the list by naming companies that pay corporate income tax but no other types of taxes, such as on property. Such companies have no operations in South Ossetia and have proliferated in the territory over the past three years, according to tax-office head Vladimir Kadzhaev. The lawyer in eastern Ukraine specializing in international trade said he recognized some of the companies on the list.

The companies paid around \$600,000 in taxes on the profits from revenue of about \$150 million in the first half of this year, according to the document and interviews with Kadzhaev. The revenue total represents an estimate for the overall sum of money funneled between eastern Ukraine and Russia through South Ossetia, according to Kadzhaev.

The flow of funds is nearly twice what it was last year. In the first six months of 2017, South Ossetian companies doing business with eastern Ukraine reported revenue of \$90 million at the current exchange rate, according to Kadzhaev.

The company that is the biggest taxpayer on the tax office’s list is RTK, initials that are commonly used for the Republican Fuel Co., an operator of 52 gas stations controlled by the rebel government of the Donetsk People’s Republic. The records suggest it buys fuel from Russia and pays for it via South Ossetia.

A representative of the fuel company’s marketing department said its bosses were unwilling to comment on South Ossetia’s role in their business.

“They thought the info was too political,” the representative wrote in an email. Appending a frowning-face emoticon, he added, “We’re scared.”

The United States in January imposed sanctions on a South Ossetian-registered company called Vneshtorgservis for exporting coal out of the separatist territories via Russia. Kadzhaev and other South Ossetian officials said they had no knowledge of the company, and its representatives could not be reached.

The South Ossetian government is now working to replicate the country’s middleman role to offer trade links to other internationally ostracized territories that are close to Russia, said Dzhigkaev, the deputy head of the South Ossetian Chamber of Trade and Industry.

Bibilov met with Syrian President Bashar al-Assad in July. South Ossetia now plans to open a representative office in Damascus.

South Ossetia also signed business and economic cooperation agreements with Crimea earlier this year, and officials from the fellow pro-Russian breakaway territories of Transnistria and Abkhazia make regular visits, according to reports by Russian media.

“We have very big plans for turning our state into a transit corridor for various kinds of flows of goods,” said Dzhigkaev. “We don’t fear sanctions.”

The growing role of South Ossetia in Moscow's financial outreach to the region creates a quandary for Georgia.

Georgia's government, like the West and almost all other governments, considers South Ossetia to be Russian-occupied Georgian territory. But Georgian officials indicated they did not want to raise too much of an outcry.

Georgia still has not restored diplomatic ties with Russia, which it severed after the 2008 war. But relations have gradually improved, and a resurgence in Russian tourism and trade has pumped much-needed cash into the Georgian economy. Georgian officials say they are focused on reconciling the population of Abkhazia and South Ossetia with the rest of Georgia.

"Unfortunately, we know" about the financial flows from South Ossetia to eastern Ukraine, said Tsikhelashvili, the Georgian government minister dealing with the breakaway territories. "But not much can be done at the moment."

In eastern Ukraine, the two separatist governments refused to allow The Post to visit their territory and declined requests for telephone interviews.

Kremlin's point man

The Kremlin's point man for the breakaway territories in Ukraine and Georgia is Vladislav Surkov, a former deputy prime minister who now works as a personal adviser to Putin.

Emails leaked in 2016 by Ukrainian hackers showed his office closely involved in how the territories are run, reviewing expense reports from Donetsk and draft legislation in Abkhazia. At a Tskhinvali celebration in August marking the 10th anniversary of Russia's recognition of South Ossetian independence, Surkov waxed lyrical on the territory's "courage" in recognizing the People's Republics of Donetsk and Luhansk.

"This financial, trade, economic, legal and organizational infrastructure created in South Ossetia for these two republics is a lifeline amid the blockade of the Kiev regime," Surkov said, according to Russia's Tass news agency.

Surkov declined an interview request.

Just as a Post reporter was asking South Ossetia's Bibilov about Surkov during an interview in the president's office in Tskhinvali, a beige telephone rang. The phone had no dial or a keypad. It sat next to the Putin memorabilia.

Bibilov stopped the interview mid-sentence. He picked up the phone and then, with an amused expression, mouthed "Surkov!" before stepping out of the office.

He came back after several minutes.

"It was business," he said.