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Sergei Dubinin, CBR Ex-Governor: “Making Government Financial Policy Comfortable For Everyone Is A Sure Path To Inflation”

Russia has been under the sanctions, unprecedented in global history, for over three years. Covering the whole economy, these sanctions focus on its two key sectors – oil and gas and finance. It was the monetary institutions of our country that had taken the first and the hardest blow in February – March 2022: dollar-denominated assets of leading banks were frozen; $300 billion of international reserves abroad were frozen; Visa and MasterCard payment systems announced of suspending operations in the RF. These and further measures, such as SWIFT service disconnection, SDN List entry, correspondent account closures, resulted in a completely new image of the Russian financial system. What is special about it? This is explained by Sergei Dubinin, Ph.D (Econ), Professor of the Economic Department of Lomonosov Moscow State University, Chairman of the Central Bank of the RF in 1995-1998.

Sergei Konstantinovich, how would you describe the current status quo of the Russian financial sphere?

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The situation is very challenging. It is challenging for all – for the federal treasury, for the banking sector and for other market institutions. Under the SMO, the structure of the state budget has changed: of the total ₽41 trillion, about ₽16 trillion are allocated to defense and security expenditures. Of course, this is a significant increase versus the peaceful year of 2021. Nevertheless, the government is trying to keep high levels of non-defense spending: social benefits are the second largest budget item. And this combination, firstly, resulted in overall budget volume increase, and secondly, led to a budget deficit over the latest three years. Moreover, the deficit is to be covered both with the funds from the National Wealth Fund and with the funds from federal bond issue. This is not the structure that had been in place before 2022.

Plus, we have growing fiscal revenues, which could largely be explained by the transition from the flat tax rate to progressive taxation. The government debt is still below 20% of GDP, and this is an extremely low level, uncharacteristic of developed countries, where it generally approaches 100% of GDP. This is proof of a sustainable budget. At the same time the economy displays growing demand for raw materials, hardware, processing industry goods. And the consumer demand is spurred by higher salaries of MIC workers, military personnel and their families. Overall, the so-called budget spending drive increases not only government expenditures, but also drives up worker salaries.

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There is one global downside to all of these – high inflation. Is that so?

Indeed, because the demand at commodity markets is ahead of supply. The demand is soaring, especially for food, which in turn gets more expensive faster. These challenging conditions apply both to government and to private sectors, and the banking, lending sector is by and large private. Since banks display continuous growth of operations both with assets and with liabilities, a certain balance needs to be maintained, a bank margin ratio has to be supported. In 2024 the loan interest rate exceeded the deposit rate by about 4,5–5%. Raising its key rate, the Bank of Russia is trying to hold prices down by regulating the volume of loans (both corporate and consumer) and by making loans more expensive.

The situation with deposits is challenging but largely well-balanced. Today deposit rates are on the average at 18-20% per year, and quite a few deposits are linked to the changing CBR key rate. This enables at least keeping the inflation under control, with the inflation level being rather high at about 10%. While it is not an explosive transition or hyperinflation (like 1000% in 1992-1993), this still requires extra effort to support the level, controlled by the monetary authorities, primarily by the Bank of Russia.

How legitimate is the criticism of the regulator mostly coming from large business representatives, speaking of large scale corporate bankruptcy risks under the conditions of super high loan rates?

Interests of the economy are not limited to requests by individual players at the economic field, even if they are majors. No task is more important than maintaining stability of the monetary system. Of course, living with 4% inflation, targeted by the CBR, would be better, but today it could not be achieved for objective reasons. In 2021–2022 developed economies had growing inflation, and it took about three years to slow it down. Indeed, the inflation was relatively low, 7-8% at most, but still far from 2%, which previously passed for normal. You cannot achieve this in the snap of the finger or by simply adjusting the regulator’s key rate one or another way. Inflation is a much more complex phenomenon.

Letting all of the monetary policy loose even for a short time, making it comfortable for everyone is a sure path to hyperinflation. This is exactly what happened in 1992–1993, when companies were allowed to offset their debt. It seemed like their money was put to good use. But the money never disappeared from the economy, and ultimately the prices literally exploded. Such mistakes shall never be allowed to happen again, and no one is calling for such actions. But everyone wants access to subsidized loans, the share of which in the corporate lending sector today is at about 15%. This means that 15% of the total outstanding corporate loan debt is repaid at lower rates. If a subsidized loan is issued at, let’s say 5% to 10%, then a

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bank will get reimbursed by the state budget for the part that is below the current market rate of twenty percent.

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How much would this be in terms of money?

Trillions of roubles. This is why it is impossible to provide subsidized loans to everyone. Otherwise, we would need to actually bring the key rate down, which would lead to inflation of over 100%. This poses the question, how could banks make money and pay interest on deposits in this case. A drastic reduction of rates would provoke bank runs. It is likely that money will be withdrawn, released to the market to buy goods as quickly as possible. This would make about ₽55 trillion in additional demand. Price growth would be stimulated twice, and its consequences are well known not only from Russian experience. Argentina's economy has been "seesawing" for many decades: a tougher monetary policy is followed by an abrupt easing, following business and popular demands, calling for affordable loans. This results in yet another outburst of inflation.

It is easier to get into this cycle than to get out of it. The fact that Russia managed to escape this after all the cataclysms of 1990s is a great achievement. Fortunately, our monetary authorities realize that this path is unacceptable, and we must not demand anything else of them. Of course, the situation with strong demand cannot be cardinally changed by key rate changes only, while there is an accumulated money overhang. This situation will not change, regardless of any actions by the CBR. This means we should stimulate supply.

In what way?

It would not be enough to just offer lower rate loans. The manufacturing sector experiences shortages not so much of money, but of labor and production capacities. Where do we get labor to work at defense industry plants or in the textile industry? Who is going to invest, which technologies and machinery should be procured? Where do we get modern equipment that it unsanctioned, which is easy to buy and install? There are many issues. These are related to labor productivity and to getting capital investments. There is yet another factor — timing. It would take at least a year to build and commission even a mid-sized factory.

Even during the best years, the volume of capital investments in Russia amounted to about 24% of the GDP, and the average figure would be 20%. And in China this figure reached up to 35-40% during heyday, enabling the country to achieve a colossal breakthrough. Today the Russian GDP is ₽200 trillion, accordingly, a fifth part should go to investment, and this would require conditions for payback. Is there any other way to convince potential investors to put money into production? Moreover, if inflation goes rampant, this issue goes away on its own. There is also the risk of going over the top in fighting inflation and

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falling into a deflation trap (sliding prices), which arises due to a lack of investments. Naturally, the issue could be resolved by forcing more money into the economy. But today, under the conditions of sanctions in place, large defense expenditures, only one thing is left to do – support some sort of a balance, however fragile, in the financial system.

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The Russians keep over ₽50 trillion in banks. Is there a threat in this? How likely is a scenario when people start simultaneously withdrawing money from their accounts for some reason? And the state, in its turn, would instruct banks to "freeze" deposits.

First**,** only current deposits can be withdrawn quickly, these amount to about ₽15 trillion over the country. For the rest of deposits, you have to wait for deposit expiration date or lose interest on it. Panic could be sparked by two conditions: a plunge in deposit rates and an incredible acceleration of inflation, when people could decide to save their money at any cost and buy, for example, sacks of sugar or buckwheat. Those people who had lived through the Great Patriotic War, lived on slender means, but all of them had pasta, soap and salt in stock. A transition to this type of consumer behavior would be a disaster. I, as someone who was born in 1950, do not believe in this scenario. But our inherited memory, things we heard from our parents, do not let us all, including the young people of today, be skeptical about this.

Now let's discuss various "freezes". What's the reason for this, which task would this resolve? If high rates are balanced out with prices, there is no need to freeze anything. Money is safely kept in banks, but this does not mean it is kept there as banknote stacks. The money is issued as loans, partially used to purchase securities, and including – precisely for the account of retail and corporate deposits banks are buying OFZ (federal loan bonds), thus financing budget deficit. And what would happen in case of a freeze, would we stop making OFZ payments as well? Will the state budget save anything? I do not understand what would be the purpose. And how would the Russian banking sector operate if it loses trust? The answer is – it would not: this would mean an actual liquidation of the market-based banking system. Instead of bringing their money to banks, people would spend it on salt, pasta and detergent.

As of November 2024, the total volume of bank loans to Russians is over ₽38 trillion. Could this bring any negative implications?

I would not call this debt burden excessive. The share of dormant debt in the consumer lending sector is only about 2,5-3%. All other debts, including mortgages, are more or less serviced. Individually, people in general stick to common sense, I cannot say that Russians are totally illiterate in terms of finance. Generally, loans are taken out by those households that understand how they are going to repay them, used to carefully considering their expenses. Of course, there are borrowers for whom a new loan is the only way available to repay an existing loan. These borrowers most often get into a hopeless situation. But they

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make up only a small share. Let’s say, individual entrepreneurs or small businesses sometimes have to file for personal bankruptcy, but these are also few. There is yet another narrow category of people who take out microloans “till payday” from microlenders. They offer very high rates, but for small amounts – up to ₽10 thousand.

Is the banking system of the country stable?

It is. In 2023-2024 banks (now there are about 330 banks in the country) got ₽2–2,5 trillion in profits annually. At the same time, 11 systemically important credit institutions account for up to 80% of all bank assets and correspondingly, deposits (liabilities). This means there is huge concentration of capital: essentially, the Russian economy is serviced by 30 largest banks. In and of itself, it is a rather complex mechanism with fine-tuned procedures. Internal risk assessment in banks is the cornerstone of their operations. Under the sanctions, the sector demonstrates performance worthy of respect.

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