"Sanctions and Financial Repression in the Currency Market" by Itskhoki and Mukhin

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Introduction

- We are not in Kansas anymore...
  - Tariffs, trade wars, and financial sanctions
- Potential policy responses:
  - Foreign exchange interventions, capital controls, and financial repression
- This paper: should financial repression be used? if so, when? and why?

Setup

- Small-open economy model based on Itskhoki-Mukhin (2025)
- Three key ingredients:
  1. Price-rigidities in non-tradeable sector $\rightarrow$ role for monetary policy
  2. Segmentation: households cannot access international financial market
     - Can open foreign-currency deposits/bonds in government-bank
  3. Dollars in utility function: nonpecuniary benefits from foreign-currency holdings

The model in three equations

- Optimal tradeable-non-tradeable bundle:

$$\frac{C_{Ft}}{Y_t} = \frac{\gamma}{1-\gamma}\left(\frac{\xi_t P_t^*}{P_t}\right)^{-\theta}$$

- Country budget constraint (gov't plus households):

$$\frac{F_{t+1}^*}{R_t^*} - F_t^* = NX_t^* = Y_t^* - P_t^* C_{Ft}$$

- Optimal demand for foreign currency B_{t+1}^*:

$$\beta R_{Ht}^* \mathbb{E}_t \left\{ \frac{P_t^*}{P_{t+1}^*} \left[\left(\frac{C_{Ft}}{C_{Ft+1}} \right)^{\frac{1}{\theta}} + \kappa C_{Ft}^{\frac{1}{\theta}} \left(\Psi_t - \frac{B_{t+1}^*}{P_{t+1}^*} \right) \right] \right\} = 1$$

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  - Financial repression: $\downarrow R_{Ht}^*$, effectively prevent $\uparrow B_{t+1}^*$ through taxation

Main results

- Ranking of policy responses to sanctions (e.g. $\uparrow \Psi$) in representative-agent world :
  1. Sell reserves: best option if reserves available
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- Application to Russia

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    - e.g., debt stabilization post WWII (Reinhart and Sbrancia (2012))
- Paper adopts an broader view:
  - Clearly, all financial repression requires some form of capital controls
  - But what (if any) is the boundary between capital/FX controls and repression?
  - Fiscal dimension? Minor role in the paper

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- Perhaps add short discussion stressing conceptual point:
  - Depreciation-related externalities could make repression optimal
  - For instance, balance-sheet mismatch of constrained domestic banks
  - In paper: extensions (TAwS, contractionary depreciation) have this flavor
    - Group them under general conceptual discussion

Comment 3: Is Russia a good testing ground for the theory?

- Model insight: financial repression useful to "undo" Ψ shocks
  - Implement allocations $(C_{Ft}, \xi_t, F^*_{t+1})$ that satisfy:

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- Natural question: what did Russian "shocks" look like?

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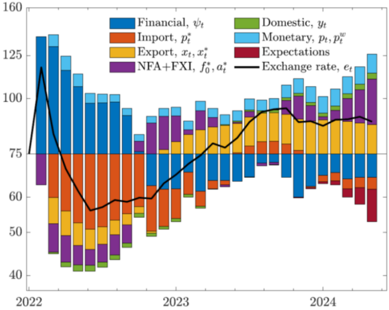
- Quantitative exercise decomposes ξ in light of model

(b) Ex-post calibration



- Match $F^* - B^*, P, P^*, Y, Y^*$ from data
- Ψ obtained as a residual to match the evolution of ξ
  - Residual includes both, Ψ-shock and financial repression
  - Not informative on use of financial repression...
  - ...but it does suggest that Ψ-shock was not negligible (at least initially)

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- One possible reading of Russian experience:
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  - Some measures restricting demand for US$ between March and May 2022
- What should we conclude?
  - Was financial repression minimal? If so, unsurprising in light of theory?
  - Especially if compared with other crises (e.g. Russia 1998)
    - Significant role of repression, large fiscal component (e.g. D'Erasmo et al. 2024)
  - Am I missing something?

Conclusions

- Paper will make a very nice addition to EP: PEGI
- Sharpen few key insights/messages:
  - Distinction between financial repression and capital controls
  - Financial repression can only be optimal with additional frictions / externalities
  - Model is well-suited to Russian experience: Ψ-shock was sizable
  - Takeaway: did financial repression play a key role in Russia?