Sanctions and Financial Repression in the Currency Market

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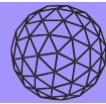
Economic Policy
Papers on European
and Global Issues



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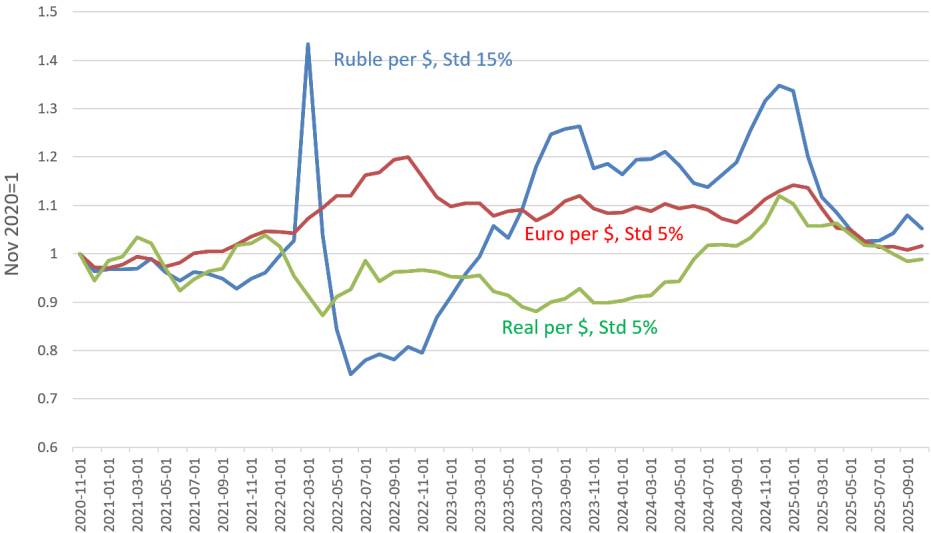
Outline

- Overview on financial repression (FR)
- Financial repression in Itskhoki and Mukhin (IM)
- Stripped down version of IM: why FR does not work and Foreign exchange interventions (FXI) do?
- Conclusion

A quick overview on financial repression (FR)

- FR: government policies distorting financial decisions of private agents
- Examples:
  - force banks to hold certain amount on government bonds
  - tax purchases/returns of foreign assets
- Goals of FR
  - increase government revenues (Reis, 2025)
  - if equilibrium without FR is inefficient/undersirable, FR can be used to achieve a different equilibrium (second best argument, IM main focus)

Three currencies against the USD: 2020-2025



FR in IM

- a country in turmoil (like Russia or Ukraine) likely to experience large fluctuations in the exchange rate
- these fluctuations (by themselves) can possibly have adverse effects on the country
- consider a narrowly defined form of financial repression which taxes household investments in foreign currency
  - can it reduce exchange rate fluctuations (given the shocks)?
  - is this reduction desirable?

A stripped down version of IM, 1

- fixed endowment of non-tradables and tradables $y = c_N,\ y^*$
- Utility function is given by

$$U(c_N, c_{Ft}, B^*_{t+1}) = \underbrace{(1-\gamma)^{\frac{1}{\theta}} c_N^{\frac{\theta-1}{\theta}} + \gamma^{\frac{1}{\theta}} c_{Ft}^{\frac{\theta-1}{\theta}}}_{\text{Standard}} - \underbrace{\frac{\kappa}{2}(B^*_{t+1} - \psi_t)^2}_{\text{Utility from foreign bonds}}$$

- households intratemporal optimization

$$\frac{c_{Ft}}{c_N} = e_t^{-\theta} \frac{\gamma}{1-\gamma}$$

- households euler equation wrt B^*_{t+1}

$$\underbrace{\frac{\lambda_t e_t}{R_{h,t}}}_{\text{M cost of } B^*_{t+1}} = \underbrace{\beta \lambda_{t+1} e_{t+1} + \kappa(\psi_t - B^*_{t+1})}_{\text{M benefit of } B^*_{t+1}}$$

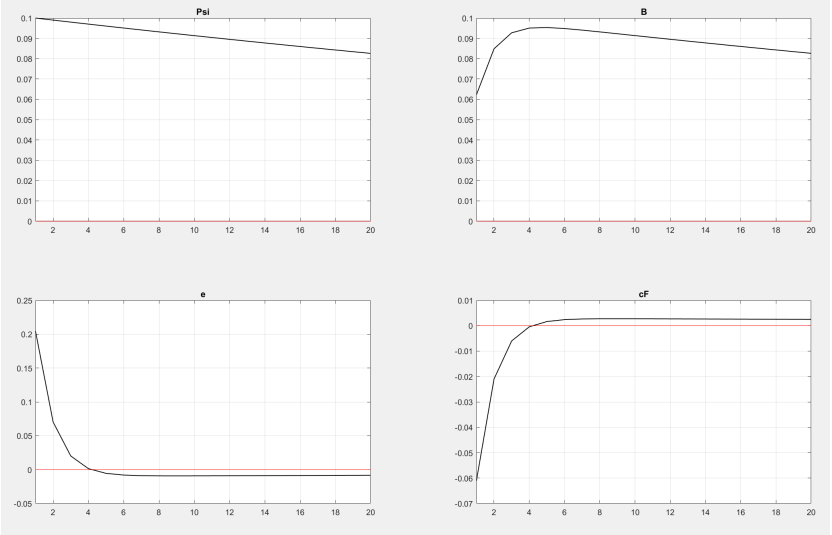
A stripped down version of IM, 2

- country budget constraint (all in foreign good)

$$\frac{NFA_{t+1}}{R_t^*} - NFA_t = y^* - c_{Ft}$$

- Demand for foreign currency comes from households and possibly through govt (FXI)
- 2 key roles of FR, i.e control of R_h:
  - generates govt revenues if $R_h < R^*$ and $FXI = 0$
  - controls the exchange rate, by lowering household demand for foreign currency

A shock to demand for foreign reserves ψ_t, without FXI



- No foreign exchange interventions (FXI): $NFA_{t+1} = B^*_{t+1}$
- As ψ_t increases two losses for households
  - Reserves lower than ideal $B^*_{t+1} < \psi_t$
  - Tradable consumption c_{Ft} falls (because increase demand B^*_{t+1} drives exchange rate appreciation)
- Note: no fundamental reason for c_{Ft} to fall. Financial shock drives deviation from international risk sharing

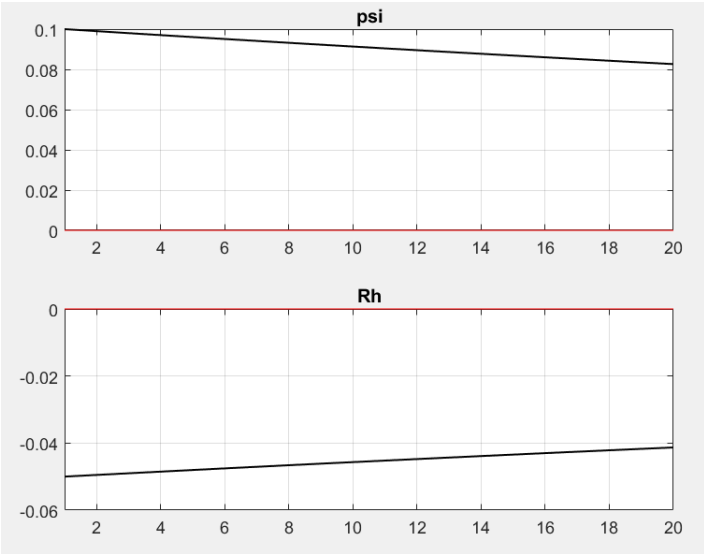
A shock to demand for foreign reserves ψ_t, with FXI

- Suppose the govt can do FXI and when household demand for foreign exchange increases it increases its borrowing abroad, so that $NFA_t = 0$ for all t
- Recall the country budget constraint

$$\frac{NFA_{t+1}}{R_t^*} - NFA_t = y^* - c_{Ft}$$

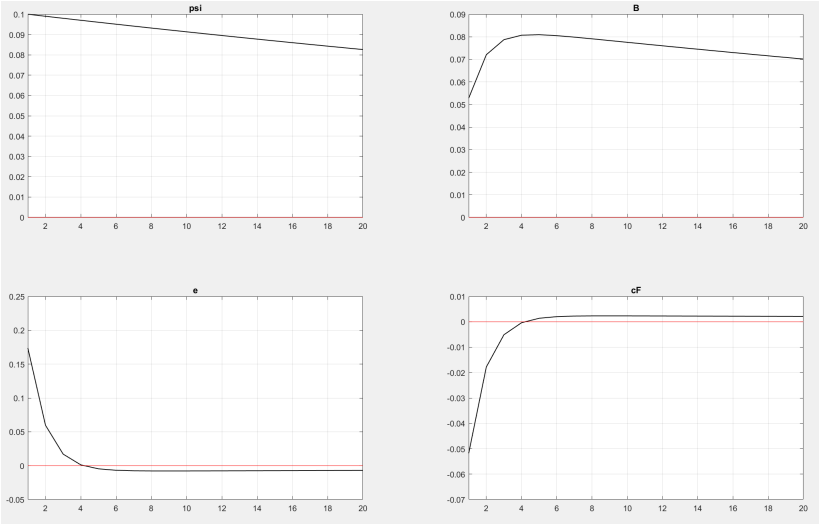
- this implies $c_{Ft} = y^*$ for all t, so both foreign consumption, real exchange rate, and reserve gap are fully stabilized
- By borrowing when reserves are needed FXI, in a sense, complete the markets and undo the effect of the shock!
- but in countries like Russia and Ukraine borrowing on international markets might by severely curtailed!

A shock to demand for foreign reserves ψ_t, without FXI, with FR



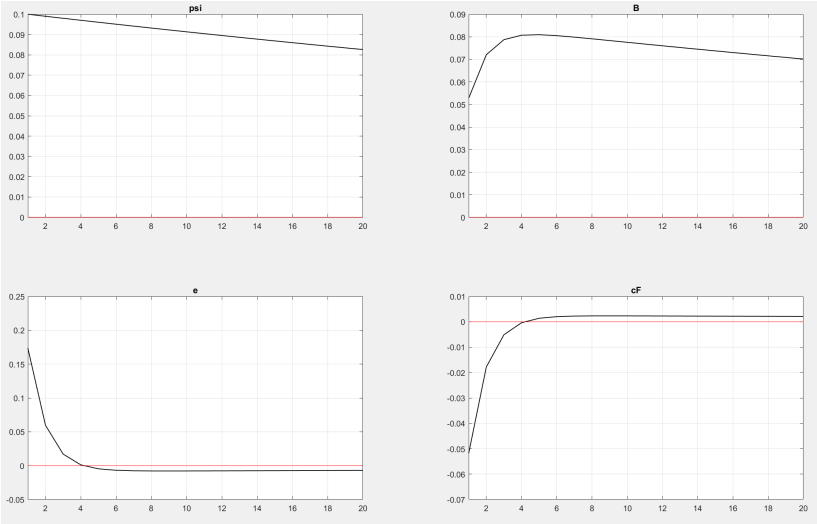
- Same shock to ψ_t
- Now in response to it, govt lowers rate $R_{h,t}$ on returns to B^*_{t+1}

A shock to demand for foreign reserves ψ_t, without FXI



- FR lowers exchange rate appreciation (from 20% to 17%) and lowers reduction in CF (from 6 to 5%), good however..
- ..FR increases the reserve gap (from 4 to 5%)

A shock to demand for foreign reserves ψ_t, without FXI



- FR lowers exchange rate appreciation (from 20% to 17%) and lowers reduction in CF (from 6 to 5%), good however..
- ..FR increases the reserve gap (from 4 to 5%)
- can FR reduce the fluctuations in exchange rates (given the shock)? YES!
- is this reduction desirable? NO, because it comes at a high cost

Why FR does not work and when could it be useful? 1

- When RA increases B^*_{t+1} in response to a shock, she already internalizes the cost of lower C_F (which is reflected in the appreciated e), so no externality!
- exchange rate movements are large but not inefficient (given the shock and the market structure)

Why FR does not work and when could it be useful? 1

- When RA increases B^*_{t+1} in response to a shock, she already internalizes the cost of lower C_F (which is reflected in the appreciated e), so no externality!
- exchange rate movements are large but not inefficient (given the shock and the market structure)
- Now consider a world where B^*_{t+1} are purchased by unconstrained agents, but there are other agents in the economy with USD denominated debt and local currency revenues
- The exchange rate appreciation driven by the purchase of reserves by uncostrained agents tighten of the constraints of debtor agents, and this is not internalized by the unconstrained
- Govt might want to impose FR to make unconstrained agents internalize the cost of exchange rate appreciation on the other agents
- note however that even if this context if FXI are available, they are still the more desirable option!

Why FR does not work and when could it be useful? 2

- The other important feature of FR is that it can generate revenues for govt, when $R_h < R^*$ and $FXI = 0$
- Government borrows in foreign currency at rate R_h domestically and reinvest at rate R_* internationally
- FR revenues come at the cost of a distortion, however if other government revenue sources are severely constrained (plausible in war times), FR might be desirable too

Conclusions

- Oleg and Dima papers are often not immediate to digest
- However typically once digested they are deep and insightful!
- This one is no exception, and it brilliantly elucidates when FR can and can't be useful in response to a shock hitting an economy in turmoil