

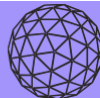
Sanctions and Financial Repression in the Currency Market

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Disclaimer: The views expressed herein are mine and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System

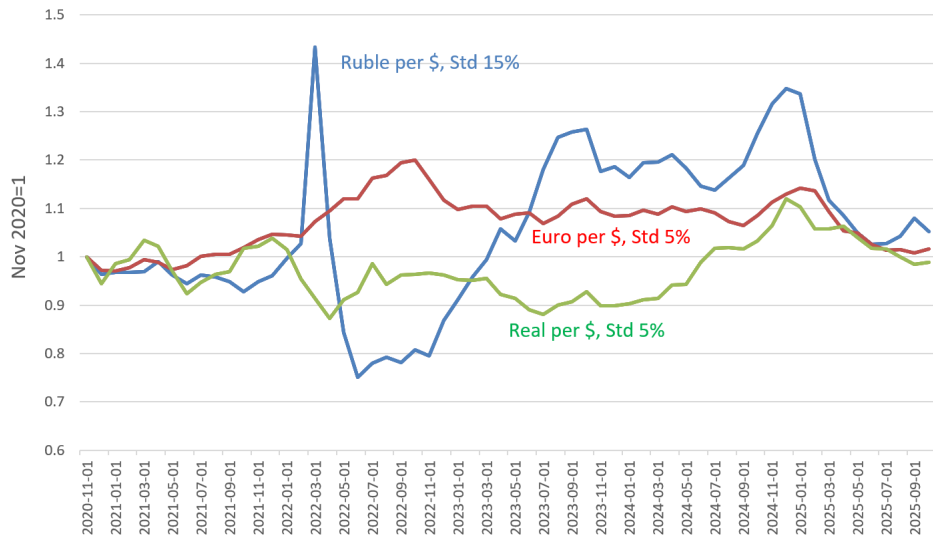
Outline

- ▷ 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}^*

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

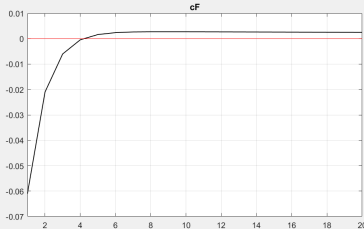
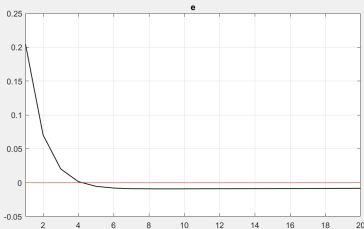
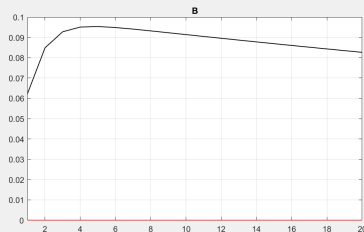
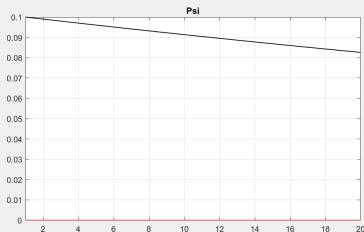
A stripped down version of IM, 2

- ▷ 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 cF_t falls (because increase demand B_{t+1}^* drives exchange rate appreciation)
- ▷ Note: no fundamental reason for cF_t to fall. Financial shock drives deviation from international risk sharing

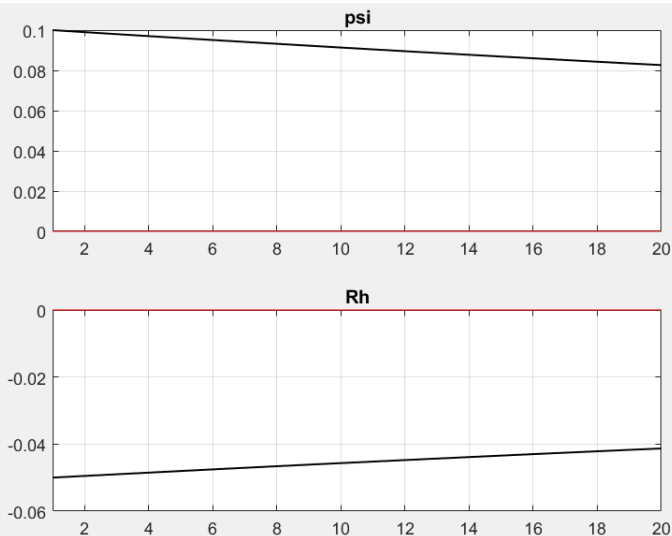
A shock to demand for foreign reserves ψ_t , with FXI

- ▷ 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

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

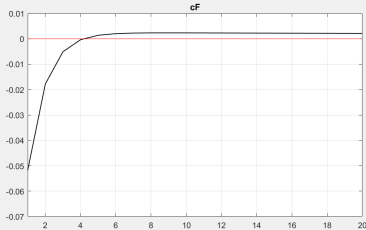
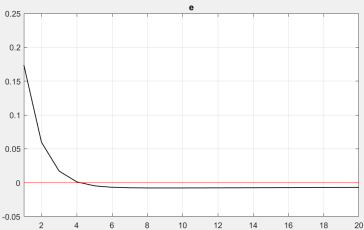
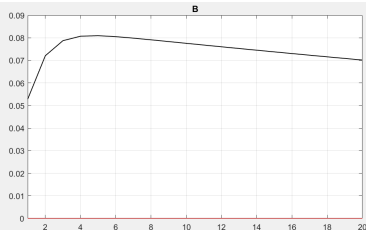
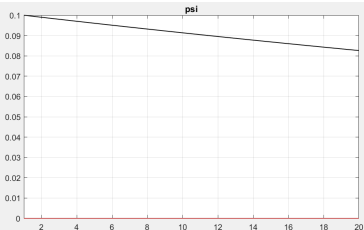
- ▷ this implies $c_{Ft} = y^*$ for all t , so both foreign consumption, real exchange rate, and reserve gap are fully stabilized
- ▷ By borrowing when reserves are needed FXI, in a sense, **complete the markets** and undo the effect of the shock!
- ▷ but in countries like Russia and Ukraine borrowing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

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



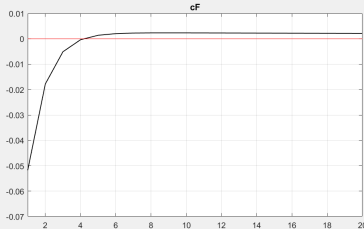
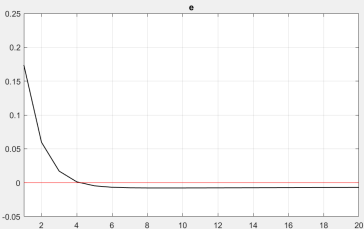
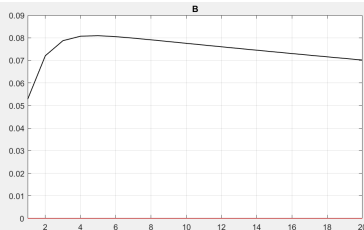
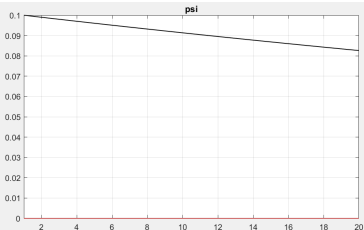
- ▷ Same shock to ψ_t
- ▷ Now in response to it, govt lowers rate $R_{h,t}$ on returns to B_{t+1}^*

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 unconstrained 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