Comments on "Financial Repression and the Currency Market under Sanctions"

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February 3, 2026

1 Introduction

The global economy is increasingly shaped by geopolitical tensions, disruptions to capital flows, and the widespread use of trade and financial sanctions. Against this backdrop, Itskhoki and Mukhin (2025) study the role that different policy instruments can play in cushioning economies against such shocks. Their focus is on financial repression, broadly defined as any policy that lowers the private return on specific assets, and in particular on repression applied to assets denominated in foreign currency.

The paper makes three main contributions. First, it provides a tractable framework to formalize financial repression in an open-economy setting with currency demand shocks. Second, it delivers normative results on the circumstances in which repression is, and is not, part of an optimal policy response to sanctions. Third, it applies the framework to shed light on Russia's policy response to the 2022 imposition of international sanctions. In this discussion, I briefly summarize the analytical framework used by the paper, before turning to four broad questions regarding the paper's approach, results, and application.

2 The Framework: a Small-Open Economy with Sanctions

The paper uses the small-open economy of Itskhoki and Mukhin (2025). I focus here on three key features of the model. First, the economy is populated by a representative household that consumes tradeable and non-tradeable goods. Second, financial markets are segmented:

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households cannot directly access the international financial markets and must rely on the domestic government to save in foreign currency (i.e., dollars). Third, holdings of foreign-currency assets enter household utility directly, capturing precautionary motives in the face of uncertainty.

In this context, financial repression takes the form of a wedge between the domestic return on foreign-currency assets and the international interest rate. This wedge can be interpreted as a tax or regulatory barrier that restricts households' ability to hold foreign currency, thereby depressing private demand for dollar assets. The paper studies the optimal policy response to a "dollar demand shock", i.e., an increase in households' marginal utility of foreign-currency holdings, which is interpreted as a reduced-form way of capturing households' increased demand for safety in response to international sanctions. The government has three policy instruments in its toolkit: it can sell official reserves to households, accumulate foreign assets on their behalf, or impose financial repression by taxing foreign-currency returns.

A central positive result is that financial repression can, in principle, completely offset a dollar-demand shock. The intuition is straightforward: foreign-currency savings can always be taxed sufficiently to neutralize the higher demand induced by the shock. Thus, the government can ensure that the pre-shock allocation remains an equilibrium by adjusting the tax on foreign-currency holdings, even if household demand for foreign currency changes.

The paper builds on this positive result to analyze the optimality of financial repression, as well as to study the role it played in the case of Russia. In what follows, I structure my comments around four broad questions.

3 What is Financial Repression?

The paper provides a precise, operational definition of financial repression in the context of the currency market. In the model, repression is essentially a tax on foreign-currency savings.

This modeling choice is sensible and it allows repression to be embedded directly into the household's Euler equation. At the same time, it raises important interpretative questions. In the traditional view associated with McKinnon (1973) and Shaw (1973), financial repression refers to policies that create a captive domestic creditor base for government debt, typically through interest rate ceilings, capital controls, or directed lending. These policies are explicitly fiscal in nature: they lower government borrowing costs and redistribute resources from private savers to the public sector.

By contrast, the notion of repression in the paper is broader and it is motivated not by

fiscal needs but by a desire to manipulate currency demand. This broader usage is defensible, as any policy suppressing private returns on certain assets is, in spirit, a form of repression. However, it also blurs out important boundaries. In practice, many policies that restrict access to foreign currency are not designed to extract fiscal resources but rather to stabilize markets or manage liquidity. For instance, should import licenses, which are commonly used to constrain demand for foreign currency, be considered a form of repression? Clarifying where financial repression ends and more standard capital or exchange controls begin would sharpen the paper's conceptual contribution.

4 When is Financial Repression Useful?

The paper's main normative result is that, in the baseline representative-agent model, financial repression plays no role in the optimal policy mix. Although repression can mechanically offset a "dollar-demand" shock, it does so at the cost of reducing household welfare by distorting their savings decision. The government could achieve a superior allocation through foreign-exchange interventions to supply reserves and accommodate the shock. In this sense, repression is shown to be strictly dominated in the presence of well-functioning policy alternatives.

More surprisingly, the argument extends to the second-best setting in which foreign reserves are unavailable—for example due to foreign-asset freezes associated with sanctions. In this case, a dollar-demand shock leads to an equilibrium depreciation that reflects the scarcity of foreign currency. Absent additional frictions, however, this depreciation is not inefficient: it simply reallocates scarce foreign currency optimally between consumption and savings. Thus, financial repression cannot raise welfare even though it can be used to prevent the depreciation.

This result depends critically on the representative-agent structure of the baseline model. Indeed, the authors develop an extension with heterogeneous agents—Ricardian savers and hand-to-mouth consumers— and show that repression can be used to increase average welfare. By moderating the depreciation, financial repression protects the purchasing power of constrained consumers whose incomes are denominated in non-tradeable wages. In this sense, financial repression acts as a redistributive tool, not a stabilizing one, and substitutes for missing transfers.

These points could be clarified for the reader by grouping these and similar results under a broad conceptual discussion: in order for financial repression to be useful, depreciations must be costly. In particular, whenever exchange-rate movements impose costly externalities—for instance, due to balance-sheet mismatches or heterogeneous consumption baskets as in the ex-

tension outlined above—financial repression may become part of a second-best toolkit. Many emerging-market crises have precisely this structure, making these extensions particularly relevant.

5 Why is Russia a Good Test Case for the Theory?

The paper uses the model for a quantitative exploration of Russia's policy response following the 2022 invasion of Ukraine and the imposition of sweeping financial sanctions. According to the theory, financial repression should be particularly useful in the presence of large dollar-demand shocks. Thus, whether Russia is a good testing ground for this theory of financial depression depends on the shocks that it faced as a consequence of Western sanctions.

Many of the most salient sanctions faced by Russia were trade-related: restrictions on imports of technology, and embargoes and price caps on exports of crude oil and refined products. Differently from dollar-demand shocks, these directly affect export revenues, import availability, and thus the country's intertemporal resource constraint. Hence, financial repression becomes less effective because the exchange rate responds not merely to changes in household behavior but to a shift in the availability of foreign currency.

The authors perform a quantitative exercise in which they calibrate some parts of the model (e.g., reserve accumulation, export revenues) with actual data, while backing out the implied dollar-demand shocks as a residual to match the observed evolution of the exchange rate between 2022 and 2024. The key takeaway of the exercise, in my view, is that the dollar-demand shocks retrieved in this manner appear sizable, especially at the beginning of the period.

I have two comments on the quantification. First, it should be structured around a central message: namely, to the extent that the estimated dollar-demand shocks are large, it shows that Russia provides a sensible testing ground for the theory. Second, it should stress that – being a residual – these shocks capture both shifts in the demand for foreign currency and any repressive measures that may have been adopted. Thus, the quantification has nothing to say about whether Russia actually used financial repression or whether it was effective. This leads to my last comment.

6 What do We learn from the Russian Experience?

As the reader approaches the end of the paper, a natural question looms in the background: did Russia meaningfully deploy financial repression in response to Western sanctions? The evidence

suggests some targeted and temporary measures—most notably the 12% fee on selective foreign-exchange purchases introduced in March 2022—and the authors convincingly document their impact, including the diverging behavior of taxed versus untaxed currencies. Yet, when viewed against earlier crises (e.g., Russia 1998) or against the more pervasive and persistent repression observed in economies such as China or Turkey, Russia's overall stance appears relatively modest and short-lived.

What should we ultimately infer from this experience? One interpretation is that Russia consciously refrained from broad-based repression—an outcome that aligns with the model's insights. If sanctions operated primarily through the trade balance rather than through a higher demand for foreign currency, repression would have offered little traction. A different reading, however, is that the short-lived measures were precisely what prevented a far more severe depreciation of the Ruble, thereby averting deeper economic disruption. Even if they can only provide a speculative answer, the authors cannot avoid addressing this question. It is the natural culmination of the paper—what the reader wants to learn after engaging with the model, the policy analysis, and the quantitative exercise.

7 Conclusion

Itskhoki and Mukhin provide a simple yet insightful framework to analyze the effectiveness of different policy instruments in responding to sanctions. The framework clarifies the conditions under which financial repression can or cannot be justified, and their application to Russia illuminates both the model's strengths and the complexities of real-world crises. In my view, the paper could be further strengthened by offering sharper discussions of the nature of repression, the conditions under which it is most effective, and the insights and lessons that emerge from the Russian experience.

References

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