Sanctions and the Exchange Rate

ITSKHOKI AND MUKHIN

Discussion by Thomas Drechsel (University of Maryland)

AEA Annual Meetings

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WHAT WE LEARN FROM THIS PAPER

- After sanctions are imposed on an economy
- the exchange rate might depreciate
- or the exchange rate might appreciate
- while the allocation and welfare can be affected in an identical way

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  → reserve accumulation; monetary loosening
- or the exchange rate might appreciate → import limits
  → financial repression
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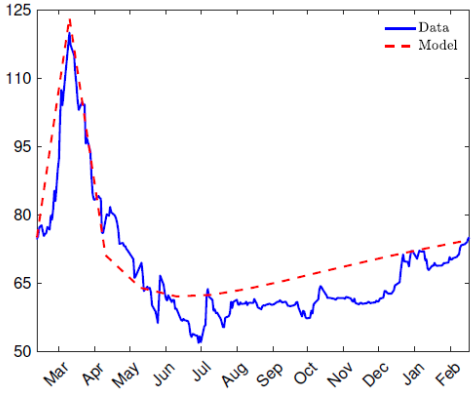
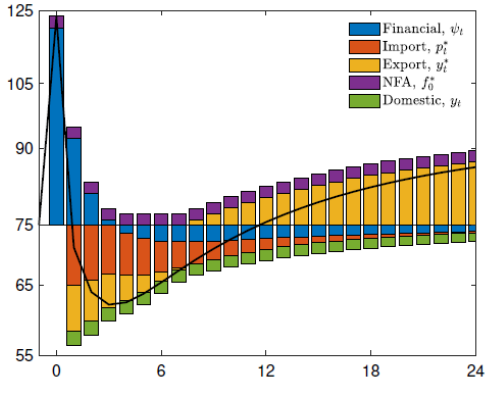
⇒ **exchange rate dynamics are a poor "measure of success" for sanctions**

HIGHLIGHTS OF THIS PAPER

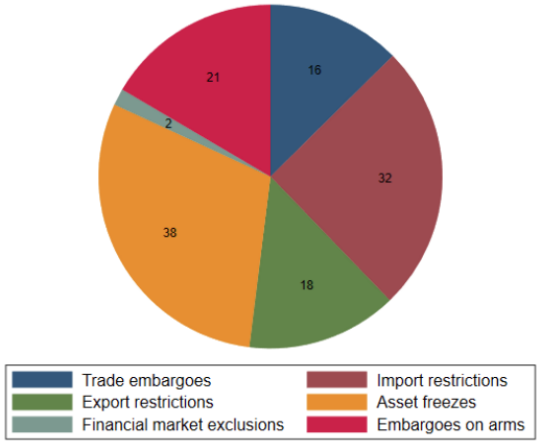
- Important topic: ongoing discussion around the effects of sanctions
- Parsimonious model that generates lots of insights
- Careful empirical exercise: Ruble dynamics in 2022/23

INSIGHTFUL ANALYSIS





NOT ONLY RELEVANT FOR RUSSIA IN 2022/23



- Sanction types between 1914 and 1945 (Eichengreen et al., 2023)

PLAN FOR MY DISCUSSION

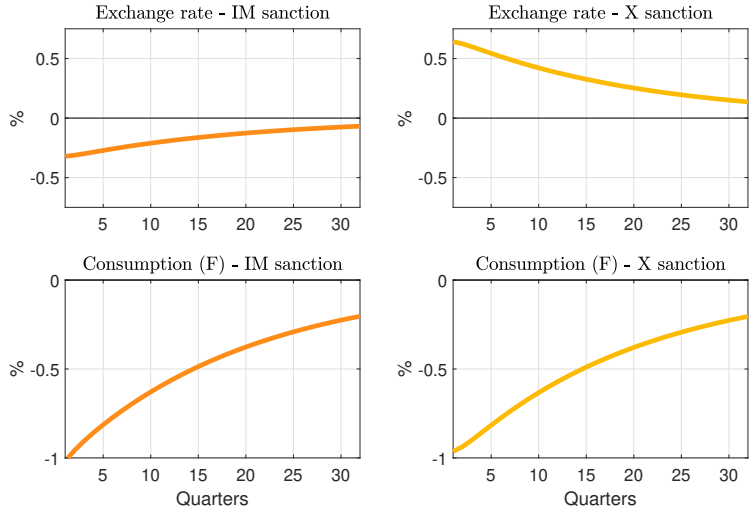
- I center my discussion around one specific theme: **anticipation effects**

1. In the model, X vs. IM sanctions do differ when they are anticipated to change
   - Examine these differences
2. Apply the model to study FX movements after anticipated "sanctions"
   - Brexit vote in 2016 $\approx$ news about future trade restrictions

HOW I PROCEEDED FOR BOTH POINTS

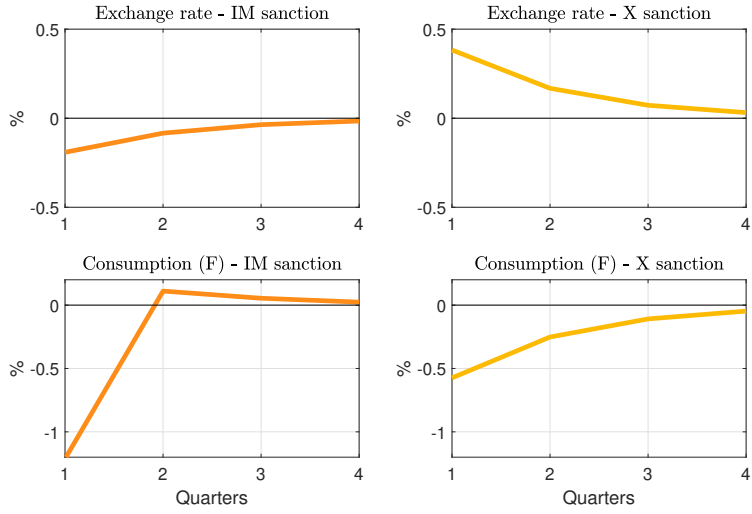
- Solve model on computer
- Simplifications: no shocks to Ψ_t; no financial repression ($R_t^* = R_{h,t}^*$); no role for foreign reserve accumulation ($F_t^* = B_t^*$)
- Additions:
  1. Stochastic shocks to Y^* and P^*, with persistence ρ
  2. News shocks to Y^* and P^*, 15 quarters into the future
  3. Monetary policy rule: $R_t = 1/\beta + \phi(\mathcal{E}_t - \mathcal{E})$
- Calibrate similar to the paper (but quarterly frequency)

IRFS - PERSISTENT SHOCKS ($\rho = 0.95$)



- Different $\mathcal{E}$ dynamics, same c_F dynamics – confirms main intuition of the paper

IRFS - TRANSITORY SHOCKS ($\rho = 0.01$)



- Dynamics of c_F now different across the sanction types

INTERPRETATION

- Suppose P_t^* increases
- If HH knows that P_{t+j}^* is lower again, will "frontload" reduction in consumption

$$\beta R_t^* \mathbb{E}\left[\frac{P_t^*}{P_{t+1}^*}\left(\frac{u_{F,t+1}}{u_{F,t}} + \dots\right)\right] = 1$$

- The red term drops out when shock is permanent

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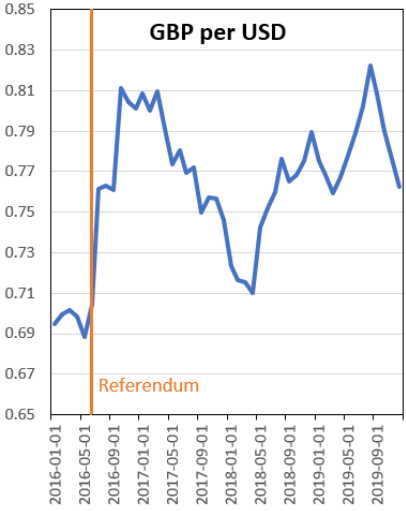
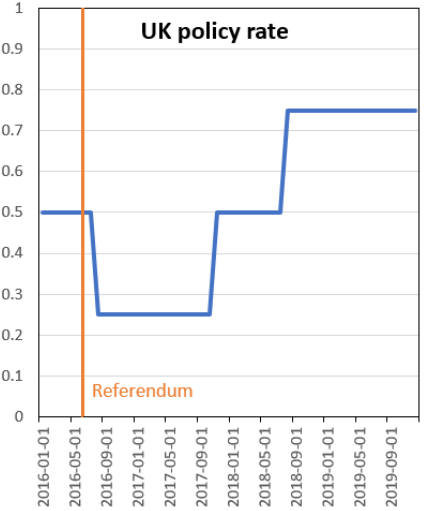
- The red term drops out when shock is permanent
- In the IRFs, the differences do not appear to be drastic
- But it might make some difference for the numerical evaluation
- Anticipation probably mattered more in other historical episodes

STUDYING BREXIT AND THE POUND IN THIS MODEL

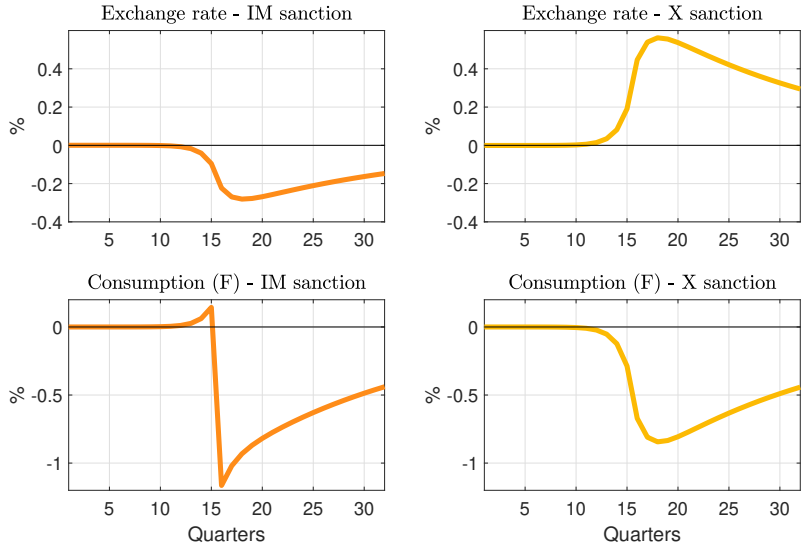
- What does the movement of the pound reveal about future trade "sanctions"?
- Relates to my own work (forthcoming in REStud): Broadbent, Di Pace, Drechsel, Harrison, and Tenreyro (2023)
  - Idea: Referendum $\approx$ news about lower productivity growth in tradable sector
- What can we learn here?
  - How do news shocks unfold in the Itskhoki-Mukhin model?
  - What kind of news shock is Brexit vote? Future import or export restrictions?
  - Think about monetary policy after the referendum

A LOOK AT THE DATA





IRFS - PERSISTENT SHOCKS, HITTING 15 QUARTERS IN THE FUTURE



WHAT DO WE LEARN FROM THIS ANALYSIS?

- Directionally, GBP depreciation in line with **expected restrictions on UK exports**, rather than UK imports
- Model generates gradual $\mathcal{E}$ adjustment, while data shows instantaneous jump
- UK monetary policy easing in Aug 2016 might explain some of early depreciation

CONCLUSIONS

- Important and insightful paper
- I explored pushing the model into a different direction: news about sanctions
- "Breakdown" of equivalence result, but does not appear to be a big concern
- Could be interesting to further study Brexit and the pound with this framework

BIBLIOGRAPHY

Broadbent, B., F. Di Pace, T. Drechsel, R. Harrison, and S. Tenreyro (2023): "The Brexit Vote, Productivity Growth, and Macroeconomic Adjustments in the U.K." *The Review of Economic Studies*, forthcoming.

Eichengreen, B., M. Ferrari Minesso, A. Mehl, I. Vansteenkiste, and R. Vicquéry (2023): "Sanctions and the exchange rate in time," *Economic Policy*.