Sanctions and the Exchange Rate

CFM-DP2022-06

Oleg Itskhoki[3] and Dmitry Mukhin[1,2]

[1]Centre For Macroeconomics, [2]LSE, [3]UCLA

We show that the exchange rate may appreciate or depreciate depending on the specific mix of sanctions imposed, even if the underlying equilibrium allocation is the same. Sanctions that limit a country's imports tend to appreciate the country's exchange rate, while sanctions that limit exports and/or freeze net foreign assets tend to depreciate it. Increased precautionary household demand for foreign currency is another force that depreciates the exchange rate, and it can be offset with domestic financial repression of foreign currency savings. The overall effect depends on the balance of currency demand and currency supply forces, where exports and official reserves contribute to currency supply and imports and foreign currency precautionary savings contribute to currency demand. Domestic economic downturn and government fiscal deficits are additional forces that affect the equilibrium exchange rate. The dynamic behavior of the ruble exchange rate following Russia's military invasion of Ukraine in February 2022 and the resulting sanctions is entirely consistent with the combined effects of these mechanisms.