Over the last two decades, the Iranian economy has been subject to a number of major adverse shocks. Some of them are external, including the eight-year war with Iraq and volatility in global oil prices. However, major imbalances in the economy were also policy driven, resulting from the control on the allocation of credit and foreign exchange, intensive exchange and trade restrictions, distortions in the pricing system including exchange rates, interest rates, and domestic energy prices in an environment of inadequate demand management. This has induced inefficiency in the allocation of resources, rendered the economy less competitive, and weakened its capacity to respond to external shocks. These factors have led to chronic inflation in Iran in the range of 20 per cent to 30 per cent over the years. Iran has a history of relatively high inflation, with CPI inflation averaging more than 17 per cent since the 1979 Revolution. Moreover, measured inflation is likely to underestimate true inflation owing to price controls and direct and indirect government subsidies. This study establishes a framework for analyzing the major determinants of inflation in the Islamic Republic of Iran during 1971-2005. We examine how liquidity (M2), Real GDP and Import Price Index (IPI) and inflation rate in Iran have changed in the events of critical importance including the oil shocks, Revolution of the 1979, war with Iraq 1980/1988 and the Five Year Development Plan in Iran after Revolution. We develop the econometric model. For this purpose, we examine the relationship between the CPI, liquidity and Real GDP and Import Price Index (IPI) in Iran in 1971-2005. We used Johansen and Juselios (1990) maximum likelihood as the estimation method.
Estimates show that the coefficient of all the repressors has the hypothesized signs and are statistically significant. Thus quantitative evidence indicates that liquidity and Import Price Index have positive effect on inflation in Iran during the period under investigation. In addition Real GDP has a negative effect on inflation in Iran. Further to identify the leading determinants of inflation, VAR method, Impulse Response Function (IRF) and Forecast Error Variance Decomposition (FEVD) are used to complete the analysis of the system. Results of Impulse Response in VAR system show that the response of the Consumer Price Index to shock in GDP is too weak and takes eight quarters to die out. However, the response of CPI to shock in Import Price Index and liquidity is positive. We found that Forecast Error Variance of the Consumer Price Index is almost exclusively accounted for by its own innovations and Import price Index. Finally, according to this study, it seems that liquidity (M2) growth can explain some part of the inflationary process in Iran. The dynamic model of price level shows that excess liquidity (M2) affects positively the inflation in Iran. The total liquidity (M2) growth plays a crucial role in determining inflation in Iran.

Keywords: Iran; Liquidity; Real GDP; Import Price Index; Inflation and VAR Method.

JEL Classification: E12, E52, E62