

Existence of Exchange Rate-Inflation Vicious Circle Hypothesis in Iran: a MSBVAR Approach

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Abstract

This research paper examined the dynamic relationship between exchange rate and domestic inflation rate as well as the existence of vicious circle in Iran. The sample covers monthly data from 1381:01 to 1396:06 Solar Hijri (about 2002:04–2017:11). The model was estimated using Markov Switching Bayesian VAR (MSBVAR) approach and Gibbs sampling.

The empirical results confirm that there are two inflation regimes that vary in variances. The Impulse-Response Functions (IRFs) imply that there is a two-way linkage between these variables in the low inflation regime and the explosive behavior was experienced in the high inflation regime. The response of inflation to one standard

-deviation shock of the exchange rate is positive and less than unity in low inflation regime. On the other hand, the reaction of the exchange rate to one standard

-deviation shock of inflation is positive too but the later was larger than former. Although the explosive behavior in high inflation regime confirms the vicious circle hypothesis in Iran.

Keywords: Inflation, Exchange rate, Vicious circle, Markov Switching Bayesian VAR, Gibbs Sampling.

JEL Classification: E31, E42, F31, F45, P24, P44.

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