Time-Varying Monetary Policy Reaction Function: The Case of Iran

Akbar Komijani
Sayed Mansoor Khalili Araghi
Hossein Abbasnejad
Hossein Tavakolian

Received: 2014/04/26   Accepted: 2014/08/20

Abstract
In this paper, we consider the estimation of a time-varying parameter monetary growth rate reaction function for monetary policy in Iran. In order to deal with implicit inflation targets and time-varying parameters, a two-step procedure is employed in estimation of the time-varying monetary policy reaction function. Considering a monetary policy reaction function with stable coefficients, we first estimate the implicit target values of inflation using Kalman filter procedure. Then, using the estimated inflation targets and explicit targets in the Development Plans, DPs, we estimate two versions of the time-varying parameter monetary policy reaction function to show the difference between what has been done and what should be done to achieve target values of the DPs. Our empirical results reveal that there has been no commitment to the target values of inflation during the first, second and fourth DPs, while the third DP was relatively successful in achieving its targets. The estimated time-varying response of monetary growth to both inflation and output gap suggests that the central bank should have reacted more forcefully to both inflation and output gap in order to achieve the targets of the DPs. The conduct of the monetary policy in recent years has been diverging from what should be done in achieving the targets of the DP.

Keywords: Time-Varying Monetary Policy; Kalman Filter; Inflation Targets; Development Plans.

6. Introduction
Today, the primary aims of central banking are price and output stability. In New Keynesian context, short-term interest rate rule suggested by Taylor