Real Money Demand, Income, and Interest Rates in Iran: Is there a Long-Run Stable Relation?

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The demand for money plays a critical role in macroeconomic analysis, especially in the formulation and implementation of appropriate monetary policy and Demand for money and its stability have received vast attention in the country specific time series studies. Developments in the unit roots and cointegration techniques and financial reforms have stimulated further empirical work on this already well researched relationship. It is now an almost stylized fact that the demand for narrow and broad money has become temporally unstable in Iran after the continuing changes to the financial sector due to financial reforms.Then the main objective of this paper is to empirically reinvestigate the long-run Iranian money demand function and its stability. The Johansen-Juselius cointegration test is employed to examine the long-run equilibrium relationship between money demand and its determinants, such as real income, inflation rate and exchange rate. Apart from this, the rolling regression procedure is also used to examine the stability of money demand function. Our results show that money demand function has been stable and financial reforms are yet to have any significant effects. Since there is no evidence for instability in the demand for money, the central banks of Iran should use money supply, instead of the rate of interest, as the monetary policy instrument.

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