International Journal of Applied Research in Management, Economics and Accounting (IJMEA)
ISSN 3023-4964
DOI : 10.63053/ijmea.20

Structural Inflation and Its Exit Policies

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ARTICLE INFO

Keywords: *Inflation, Politics, Economy, Money, Structural Inflation*

ABSTRACT

Factors causing inflation in the economy can be divided into two categories: long-term and short-term factors. The leading cause of inflation in the long term, which has led to higher average inflation in Iran compared to other countries, is the high liquidity growth over production growth. Income-expenditure disparity in the macroeconomic scale means increased expenses over national income growth. On the other hand, the cause of inflation fluctuations around the long-term trend in the economy in the short term depends on the anchor of inflation expectations (which is dependent on the unofficial exchange rate in Iran's economy) and the reaction of the monetary policy maker to these fluctuations. According to the distinction, the solutions to control inflation can be expressed in the short-term and long-term. In particular, measures that have an impact on inflation control in the short term include minimizing exchange rate fluctuations around the long-term trend of the real exchange rate, IRR governance and strengthening monetary policy by the central bank, and measures with a long-term impact in cases of quantity control and monitoring The quality of liquidity, reforming the banking system and unhealthy banks, reforming the budget structure and improving the operating balance, not using a pricing strategy to curb inflation, correcting the imbalance of pension funds, reducing the amount of available liquidity and changing the nominal anchor are summarized.

1. Introduction

Curbing inflation and creating economic growth is one of the most important goals of macroeconomics, and considering the occurrence of high and fluctuating inflation as well as the experience of shallow economic growth in previous years, these two critical goals have been set as the slogan of 2023. Regarding the strengthening of the supply sector of the economy and the growth of production, the research center of the Islamic Council has addressed this issue in several reports, including the reports on the strategic model of production support, and other reports are also being compiled and published, but in this report, the specific issue of inflation and solutions Its control is paid. Regarding inflation, various studies and the data reviewed in this report show a high correlation (in the range of 0.99999) between the growth rate of liquidity and the inflation rate for all countries in the long term. It seems that the main factor causing inflation in the long term, which has led to higher average inflation in Iran compared to other countries, is the high growth of liquidity over production growth, of course, even though liquidity growth is the most important factor causing inflation in the long term, imbalances endogenously cause it. Income is a cost in the country's economy. Income-expenditure disparity on a macroeconomic scale means that expenses are lower than national income growth, which is discussed in detail in the report.

In the short term, the main factor that can explain inflationary fluctuations around the long-term inflation rate is exchange rate changes. Since the exchange rate is historically the anchor of inflationary expectations in Iran's economy, it plays a central role in shaping inflationary expectations, leading to changes in the inflation rate in the short term. Sometimes, the role of currency in explaining inflation is explained beyond inflationary expectations, and it is said that inflation in long-term periods (for example, inflation in the 2010s) is a result of the increase in the exchange rate. This is while the theories of determining the exchange rate consider the nominal exchange rate to be a function of inflation and liquidity growth "in the long run," and the above analysis mainly originates from the fact that it is said that the above theories cannot be used in determining the nominal exchange rate of Iran. The text shows that the monetary model and liquidity changes can explain the exchange rate trend and fluctuations. *(Amano & van Norden, 1998a)*

2. Structural inflation

Structural inflation means that due to the situation related to the economic, political, governmental, and cultural structure, and other such things, inflation occurs and continues. This type of inflation does not have a simple explanation of demand or cost pressure, but various and often complex factors play a role in its creation and continuation. Structural inflation is mainly specific to underdeveloped and developing countries. The critical point is that if inflation in developed countries can be treated and controlled to a large extent by applying contractionary monetary and financial policies, this is not the case with structural inflation in developing countries and the use of economic and financial policies to the purpose of dealing with inflation may not be very effective and may have high costs for such economies. Solutions to curb inflation

Based on the explanation of the factors that cause inflation, below are the solutions to curb inflation under two short-term and long-term categories. It is emphasized that the short-term and long-term division refers to the scope of the measures that can lead to a reduction in inflation in the short or long term and not the time of the start of the measures.

2.1. Short-term solutions

2.1.1. Prevention of currency impulse and minimization of rate fluctuations around the trend

The currency market, as an asset market, represents a lot of economic information, such as the state of oil sales and foreign exchange reserves, the state of the government's budget deficit, the quality of policy, the level of uncertainty, the state of international relations is all received through the lens of the exchange rate by economic factors. Considering the credibility of the central bank and the time-consuming nature of changing the monetary policy framework, as well as the view of economic activists, the continuation of the nominal anchor of the exchange rate should be considered as an undeniable bitter reality, and at the same time efforts should be made to change it, which is vital in the long-term solution section—referred to. Currently, without an efficient and immune foreign exchange market, the informal currency market plays the role of nominal currency anchor. Therefore, the essential solution to curb short-term inflation (monthly and point-to-point in 2023) in the framework of stabilizing the exchange rate is in the form of the following measures:

Removal of any mandatory rate, especially the rate of 285000 IRR and the required limit in the exchange market, the consolidation of all foreign currency supply and demand in the gold and foreign exchange center of Iran, and the management of the foreign exchange market with non-mandatory and price interventions, and adherence to Clause "T" of Article (20) of the Law The permanent provisions of the country's development programs and the full implementation of Article (44) of the resolution of the parliament regarding the "Law on the Central Bank of the Islamic Republic of Iran." *(Amano & van Norden, 1998b)*

Considering the allowed range of growth and fluctuation for the path of the exchange rate in 2023, It is suggested that according to the macroeconomic variables and the strategy of stabilizing the real exchange rate, the corridor of the exchange rate path in the gold and foreign exchange center of Iran (of course, subject to prior action and the elimination of price and order interventions) should be targeted by the central bank in 2023. The bank Center should adjust its interventions to avoid leaving this domain. Of course, it is suggested that in the first half of 2012, implicit targeting (without announcement) should be ordered so that the central bank can be sure of the following by receiving feedback from expectations and this policy:

Is the target exchange rate selected correctly or not? Explaining that the central bank may reach this conclusion after some time; to anchor the expectations, it is necessary to target the average exchange rate of the exchange center and the unofficial exchange rate. How do we define the appropriate fluctuation range for the rate path?

After ensuring the above, the central bank can announce this route to the public to control their expectations. The most important reason for not introducing this policy initially is to protect the central bank's credibility.

Reforming the international payment system: increasing the quality of received currencies (in the sense of reducing the financial cost and time of the payment order transaction for import purposes), increasing the rate of return of foreign exchange resulting from foreign exchange or contracting, and preventing the outflow of capital, is possible with the establishment of an official payment system. Unlike trust-oriented transfers, the official payment system means a currency exchange system in the official framework. It is based on the brokerage account of the central bank and the banking network. It is suggested that the international settlement of goods with minor sensitivity to the exchange rate, such as essential goods (5 items), mobile phones, and auto parts, should be pursued in the framework of bilateral trade and based on the official payment system. Changing the basis of import of these goods by the country's export objectives and conducting political negotiations to create such a payment infrastructure from the countries that share the most strategic and political interests with Iran are among the most essential tools for creating an official payment system. Creating an official payment system for these types of goods will improve the transparency of the foreign exchange market, reduce the fragility of the foreign exchange market, and even reduce the cost of importing essential goods. Reducing the precautionary demand of importers by introducing currency derivatives: In case of reforming the structure of the foreign exchange market and aggregating all official supply and demand in the exchange center without price intervention and accordingly finding the authority of the discovered exchange rate, it will be possible to introduce derivative instruments such as currency futures or currency futures and exchange them by traders and the central bank. Using this tool seems to reduce the commercial precautionary demand and prevent the exchange rate overshooting. *(Beckmann, et al., 2020)*

Making it possible for the central bank to tap or receive a foreign currency credit line to face unexpected temporary shocks. For example, some Chinese parties holding dirhams in the UAE can provide their dirhams (considered high-quality currency) to the National Bank of the Emirates in exchange for receiving yuan in China. Due to sanctions risks and the availability of yuan resources at the Central Bank, concluding a contract at a trim level (in the form of exchanges and trusts) is impossible. Increasing the cost of speculation in the asset market through improving the governance of the IRR

It is necessary to implement the executive regulations of Article (14) of the Anti-Money Laundering Law focusing on the following issues to increase the possibility of identifying the factors influencing price manipulation or collusion in the market of assets such as cars, housing, gold, and currency:

- Identifying the relationships of natural persons (completion of the system of relative causal relationships of the civil registration organization)
- Identifying the relationships of legal entities (Amendment of the Commercial Law regarding the receipt of ownership information of all types of companies and the use of information available in the General Administration of Companies Registration)
- Separation of commercial and non-commercial accounts and identification of IRR transactions by the central bank
- Data sharing and intelligent use of mass information to discover and deal with speculation in cooperation with the judicial system by the Financial Information Center of the Ministries of Economic Affairs and Finance. Monetary policy of the central bank

One of the main goals of monetary policy in the world's central banks is to reduce the fluctuations of the operational target and prevent price shocks in the macroeconomy. Based on this, it is necessary for the central

bank to conduct open market operations following the permitted scope of the exchange rate path and also the policy of controlling the growth of banks' balance sheets in such a way that:
Reserves required by the banking network should be provided only through open market operations or regular facility payments. Specifically, the central bank should react proportionately to the government's macro-financial transactions that cause fluctuation and deviation from the operational goal. In other words, if the government's financial transactions lead to severe fluctuations in the interbank interest rate and changes in the monetary base, the central bank will actively intervene and prevent the deviation of the economic base and liquidity from the targeted amount. Also, suppose the central bank is forced to intervene in the foreign exchange market to return the exchange rate to its desired corridor and compensate for currency shocks. In that case, it is necessary to carry out neutralization operations to prevent the monetary base from changing from the targeted value. *(Caves, et al., 2007)*
In this situation, as long as the monetary totals are within their target range, there is no need to worry about the increase in interbank interest rate fluctuations.
By using appropriate communication policies, take advantage of the effect of announcing monetary policies and, in addition, take action in the direction of changing the nominal anchor towards the operational goal of the central bank. Holding special meetings for monetary policy, implementation of Article (54), and using the capacity of Article (10) of the resolution of the Majlis regarding the "Law on the Central Bank of the Islamic Republic of Iran" is emphasized.

2.2. long-term solutions

Controlling the quantity of liquidity and seriously monitoring the quality of distribution of liquidity and facilities in the economy: full implementation of the policy of limiting the balance sheet of banks to control the quantity of liquidity in such a way that the average growth rate of liquidity in the next three years is reduced to below 20%.The policy of limiting the balance sheet of banks has been proposed to control the growth of liquidity, which is the better performance of the policy of targeting monetary totals against the targeting of interest rates in high inflation conditions. Apart from the fact that in high inflation, controlling the amount of money is better than maintaining the interest rate, the increase in interest rates in the current conditions of the banking system in the country can lead to the aggravation of the banking imbalance and the activation of inflation from this point. In other words, one of the prerequisites for the operational targeting of the interest rate is reforming the banking system and resolving non-performing banks. The most important consideration for the implementation of this policy is the dimensions of stagnation and outsourcing of the non-governmental sector, which seems to be necessary to take the following measures to reduce the possibility of those consequences *(Chen et al., 2007)*
Accurate calculation and settlement of a part of the government's definitive debt to banks and increasing the share of financing of state-owned companies through the issuance of corporate securities instead of receiving facilities from the banking network (creating capacity to prevent outsourcing), previous monitoring of the payment of facilities to related parties and facilities and obligations Big banks and non-banking credit institutions and avoiding the limits stipulated in the relevant guidelines.

2.2.1. Reforming the banking system and unhealthy banks

As mentioned, the imbalances in the economy are the root of the high growth of excess liquidity overproduction, and one is the banking imbalance. Therefore, it is impossible to consider a sustainable reduction of inflation without resolving the activities of highly unhealthy banks and restructuring unhealthy banks. In this regard, the following actions are suggested:
- Assess the quality of banks' assets and classify banks based on capital adequacy ratio (asset-debt imbalance) and the amount of overdraft from the central bank (liquidity imbalance).
- Terminating the activities of highly unhealthy banks.
- To rehabilitate unhealthy banks, fully implement articles (27) to (29) of the Parliament's resolution on the "Central Bank Law of the Islamic Republic of Iran" (subject to exploratory, preventive, and corrective measures regarding credit institutions), which has given the central bank vast powers., is emphasized.
-Increasing the capital of state-owned banks from the government's share of the net profit of the central bank, the subject of the note of article (29) of the parliament's resolution on the "Law on the Central Bank of the Islamic Republic of Iran."
- Securitization of surplus assets of banks to increase liquidity of banks' assets and reduce liquidity risk. Reforming the budget structure and improving the operational balance of the 2023 budget
Due to the significant number of reports of the Majlis Research Center regarding proposed axes and measures

regarding the reform of the budget structure, repeating those cases will be avoided, and, in this section, only the measures that can reduce the budget deficit of 2023 will be mentioned:

2.2.2. Increasing commercial profit to compensate for the reduction of customs duties

In the budget bill of 2023, the resources from the import duties of imported goods are estimated to be equal to 890 thousand billion IRR, and according to the expert evaluation, this forecast was accompanied by an overestimation of about 300 thousand billion IRR. Regardless of the budget bill's assumptions error, the Islamic Council reduced the rate of import duties on imported goods from 4% to 1%. Reducing three percentage points in customs duties will reduce customs revenues by another 300 thousand billion IRR. Therefore, a resource deficit of 600 thousand billion IRR will be created from this place. It is suggested that the government increases the commercial profit of imported goods by considering the considerations related to different goods to realize the import tax approved by the budget law. *(Hasanov, et al., 2022)*

2.2.3. Modification of oil and gas exchange rates

The sale of currencies from the export of oil and gas condensates and the net export of gas at the price of 285000 IRR, although it is higher than the assumed rate of the budget bill, due to the overestimation caused by the number of exports and the price of oil in the assumptions of the budget bill, it is predicted that this exchange rate will lead to no Realizing the resources of note "1" and facing the budget with a deficit. On the other hand, the assumption of calculating the targeted resources in the 2023 budget bill was based on the fact that the price of the petrochemical feed gas, based on the formula of the Ministry of Petroleum, will always remain within its riyal ceiling of 70000 IRR during the year 2023. Including the rate of 285,000 IRR announced by the Central Bank, the price of petrochemical feed gas is about 50,000 IRR, and the outlook for gas prices in regional hubs is also decreasing. Calculations show that every 10000 IRR reduction in petrochemical feed gas rates leads to a 370 thousand billion IRR reduction in targeted resources. The result of announcing the exchange rate of 285,000 IRR reduces 700 thousand billion IRR from the sources of note "14" of the budget law of 2023, which leads to the imbalance of the government's budget. In this regard, it is suggested that the currency exchange rate resulting from note "1" and the base exchange rate for the feed of refineries and petrochemicals should be equal to the average sale rate of the export currency of these companies in Iran's currency and gold exchange center.

2.2.4. Providing subsidized sources of bread and guaranteed purchase of wheat

Based on the calculations, it is predicted that in 2023, at least 1260 thousand billion IRR of credit will be needed to provide the bread subsidy, for which only 1050 thousand billion IRR have been considered in note "14" of the budget law. According to the approvals mentioned above that have reduced the sources of note "14", the deficit of providing bread subsidies will increase. The shortfall of the bread subsidy is the responsibility of the state trading company every year. Due to its financial incapacity, that company receives facilities from banks and the central bank with the approval of the Board of Ministers and converts the imbalance into monetary variables. It is proposed that this part of the budget deficit be financed, which is directly converted into liquidity and monetary base through the issuance of securities. *(Rogoff & K. S., 1996)*

2.2.5. Not using pricing as a strategy to curb inflation.

Government pricing (input and output) in various industries such as automobile manufacturing, household appliances, mining, and metal industries, which are mostly not accompanied by proper and timely adjustment, causes the cash flow of the companies, as mentioned earlier, to face problems and the continuation of the companies' activities and the provision of working capital. It can only be possible by borrowing from banks and leading to the stability of increasing liquidity. It should also be noted that since the pricing for all goods does not happen at the same rate and is adjusted with a delay, it will lead to price differences and changes in relative prices in the economy. The price difference in the economy also leads to the non-optimal allocation of resources and the reduction of production in the economy, which was explained in the section on the negative consequences of inflation. Based on this, in short, if the policymaker seeks to control inflation through pricing, he is facing a contradiction and a violation of the purpose because of the mandatory control of prices (market regulation approach to the issue of controlling inflation) even if he can control inflation "in some items" and "for a limited period." To "postpone" due to the non-optimal allocation of resources in the economy (changing relative prices through pricing) has the disadvantage of inflation. To be more precise, since it may be intensified due to the policymaker's habit and inclination towards the market regulation approach of the mandatory control of prices in the year of curbing inflation, it is emphasized that this policy not only does not play a role in reducing inflation, but firstly by causing problems in the cash flow of companies and Creating imbalances in the government budget and the balance sheets of banks leads to the aggravation of the fundamental factors that cause inflation, and secondly, due to the disturbance in relative prices, it has the harmful effects of inflation. In other words, even if it is possible to control the increase in prices in this way (which is not very likely), the adverse effects of the pricing strategy to control inflation can be more than the adverse effects of the existence of inflation itself. Correction of pension funds mismatch In the case of pension funds, all parametric and non-parametric correction measures should be put on the agenda to solve the existing imbalance. In 2022, the total financial burden caused by the government's debt-creating tasks to the Social Security organization was estimated to be around 800 thousand billion IRR, which will increase in 2023. This is while to secure this credit, only 100 thousand billion IRR are considered in Table 7, under the credits of the Ministry of Welfare, and another 700 thousand billion IRR, according to the resolution of the Parliament in Part "1", Clause "D," Note "19" in the form of clearing. The transfer of stocks and crude oil or the guarantee of principal and profit of Islamic financial bonds was approved. This is because the Social Security organization does not have the ability and facilities to clear crude oil. It is necessary to take advantage of the budget law's capacity and avoid creating a financial burden for the banking network. *(Coudert, V. & Mignon, V., 2016a)*

2.2.6. Measures aimed at reducing the amount of available liquidity

Selling bank surplus assets and collecting non-current claims are another set of necessary measures to address liquidity shortages and reduce inflation. According to the reports of the Ministries of Economic Affairs and Finance, the surplus property of state-owned and privatized banks is estimated to be around 2,000 billion IRR, which can be speeded up by using the powers of the Asset Generation Board. *(Rogoff & K. S., 1996)*

3. Conclusion

Decreasing inflation can have both positive and negative results. In a situation where economic prosperity has been achieved along with low inflation, a further decrease in inflation can disrupt the economic growth process. However, in countries with unhealthy and stagnant inflation, its reduction is usually helpful, even if it brings short-term negative results.

One of the solutions to achieve inflation reduction is monetary and financial discipline and prevention of liquidity intensification. One of the first steps to prevent an increase in liquidity is to balance the expenses and revenues of a government. In hyperinflation conditions, governments resort to more drastic measures, such as creating a new currency and using foreign currency instead of the national currency. In a situation where inflationary stagnation is present, strategies such as tax exemptions, incentives for saving and investment, and eliminating the cost of administrative procedures can be used to reduce inflation and stimulate economic growth. *(Rogoff & K. S., 1996)*

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