

Exchange Overshooting and Currency Substitution in Iran

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Abstract

If the domestic currency of a country cannot accomplish its duties, the foreign currency substitutes it. Currency substitution is a common phenomenon in developing countries, which is affected by different economic and political aspects. The main objective of this research is to estimate the relationship between exchange overshooting and currency substitution in Iran. As a part of this research, first, the Kamin & Ericsson method (2003) was used to evaluate the amount of circulating foreign currency and currency substitution in Iran's economy by using annual data from 1979 to 2020. Then, the ADL method was used to estimate the impact of exchange overshooting on currency substitution. The long-term results indicate that the exchange overshooting always increases currency substitution in Iran. On the other hand, gross domestic product affects currency substitution negatively, and war and sanctions have a moderator role in the effectiveness of the gross domestic product on currency substitution. Additionally, the effect of war has been higher than that of sanctions. Also, according to the results of the coefficient of error correction (-0/92), it takes about 13 months to reach the long-term equilibrium.

Keywords: Exchange overshooting, Currency substitution, Iran