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The Relationship Between Monetary Policy Credibility and Inflation in Iraq

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ABSTRACT

This study aimed to investigate the effect of monetary policy credibility on the inflation rate in the Iraqi economy over the period 2000–2024. The central objective of the study was to analyze how the general price level is affected by the central bank credibility index, the policy interest rate, gross domestic product, and inflation expectations over both short-term and long-term horizons. The study adopted a quantitative and explanatory approach, employing the Autoregressive Distributed Lag (ARDL) model and the Error Correction Model (ECM) to estimate short-run relationships and long-run equilibrium dynamics. The study variables included the inflation rate, monetary policy credibility index (CRED), policy interest rate, gross domestic product, and inflation expectations. To ensure the robustness of the findings, the Augmented Dickey–Fuller (ADF) stationarity test, diagnostic tests for serial correlation, functional form, residual normality, and heteroskedasticity, as well as structural stability tests based on CUSUM and CUSUMSQ, were applied. The results of the long-run model indicated that the monetary policy credibility index had a positive and statistically significant effect on inflation, with a coefficient of 0.081. This finding reflects the oil-dependent structure of the Iraqi economy and the fiscal dominance of the government over monetary policy, under which central bank efforts, in the absence of genuine institutional independence, have been unable to fully anchor inflation expectations. The policy interest rate exerted a positive and significant effect on inflation, with coefficients of 0.480 in the long run and 0.186 in the short run, supporting the existence of the "price puzzle" and the dominance of the cost channel in Iraq's financial market. Gross domestic product, with a coefficient of 0.120, and inflation expectations, with a coefficient of 0.007, also had positive and statistically significant long-run effects on inflation. The error-correction coefficient was estimated at -0.631, indicating that approximately 63.1% of short-run disequilibrium is corrected toward the long-run equilibrium path in each period. The diagnostic and structural stability tests also confirmed the validity and stability of the model throughout the study period. The findings demonstrate that the effectiveness of conventional monetary mechanisms and the credibility index in Iraq is strongly influenced by the oil-based structure of the economy, fiscal dominance, and the limited depth of financial markets. Therefore, achieving sustainable inflation control in Iraq requires reducing fiscal dominance, strengthening the genuine independence of the central bank, reforming the interbank market structure, and improving monetary transmission channels to ensure the effective anchoring of inflation expectations.

Keywords: Monetary policy credibility, inflation, ARDL model, error correction, price puzzle, Iraqi economy.



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Introduction

Inflation remains one of the most persistent macroeconomic challenges facing both advanced and developing economies because it directly affects purchasing power, income distribution, investment decisions, financial stability, and the credibility of economic policy. Although moderate inflation may accompany economic expansion, persistent or highly volatile inflation can distort relative prices, weaken household welfare, reduce the real value of financial assets, increase uncertainty, and undermine long-term growth. These effects are particularly pronounced in developing and resource-dependent economies where monetary transmission mechanisms are often incomplete, fiscal pressures are strong, banking markets are shallow, and exchange-rate developments exert substantial influence on domestic prices. Recent international evidence has also demonstrated that inflation dynamics can change substantially in response to supply disruptions, global commodity shocks, shifts in trade policy, and structural changes in the monetary transmission mechanism, thereby requiring central banks to continuously reassess both their policy instruments and institutional frameworks (1). In this context, monetary policy credibility has become a central concept in macroeconomic policy analysis because the effectiveness of monetary actions depends not only on changes in policy instruments such as interest rates or liquidity conditions but also on whether households, firms, investors, and financial institutions believe that the monetary authority is willing and able to maintain price stability. When this confidence is strong, inflation expectations may become better anchored and the inflationary consequences of temporary shocks may be reduced; when credibility is weak, however, even restrictive monetary actions may fail to produce the desired disinflationary effects.

The theoretical importance of monetary policy credibility is closely related to the role of expectations in the inflation process. Economic agents form expectations about future prices, interest rates, exchange rates, wages, and policy responses, and these expectations influence current economic behavior. Firms that expect persistent inflation may increase prices in advance, workers may demand higher nominal wages, households may accelerate consumption, and investors may shift portfolios toward inflation hedges or foreign currencies. These behavioral responses can transform expected inflation into actual inflation, thereby increasing the persistence of price pressures. The importance of inflation persistence has long been recognized in the design of monetary policy rules, particularly in economies where past inflation strongly influences current inflation dynamics (2). More recent evidence further suggests that countries with a history of high inflation may inherit policy-response patterns that differ from those observed in low-inflation economies, because policymakers and private agents adapt their behavior to the legacy of earlier inflationary episodes (3). Consequently, credibility is not merely a reputational characteristic of a central bank but a mechanism through which policy announcements, interest-rate decisions, liquidity management, and communication strategies can affect the formation of expectations and thereby influence actual inflation outcomes.

The relationship between monetary policy and inflation is nevertheless complex and may vary substantially across institutional and structural settings. In conventional monetary theory, an increase in the policy interest rate is expected to reduce aggregate demand, moderate credit creation, strengthen incentives to save, and ultimately lower inflation. Yet empirical evidence in some developing economies shows that this relationship may be weaker, delayed, or even temporarily positive because of cost channels, exchange-rate effects, financial-market imperfections, administered lending conditions, and weak policy transmission. Research on the changing transmission mechanism under inflation-targeting regimes has shown that the effectiveness of monetary policy

depends on the institutional environment, financial structure, and the responsiveness of economic agents to policy signals (4). Similarly, external price pressures associated with tariffs, imported inputs, and changes in relative prices can complicate the relationship between monetary tightening and inflation, particularly when central banks face simultaneous supply-side and demand-side disturbances (5). These complexities are especially relevant for economies such as Iraq, where the central bank operates within an oil-dominated macroeconomic structure, the banking sector remains relatively underdeveloped, and fiscal conditions can strongly influence liquidity and aggregate demand.

Developing countries often face additional constraints in using monetary policy to achieve price stability because inflation may originate from factors that lie partly outside the direct control of the central bank. Exchange-rate depreciation, imported inflation, fluctuations in food and energy prices, public expenditure, monetary financing, institutional weakness, and structural supply constraints can all contribute to sustained inflation. Comparative evidence shows that the effects of monetary policy on inflation and economic growth may depend heavily on country-specific institutional and macroeconomic conditions (6). Furthermore, monetary policy can generate broader distributional consequences because inflation and policy tightening do not affect all households and income groups equally; this issue is particularly important in developing economies where financial inclusion is limited and vulnerable groups may bear a disproportionate share of the costs associated with inflation or restrictive monetary conditions (7). Therefore, understanding inflation requires a framework that goes beyond mechanical relationships between money supply and prices and considers the credibility of monetary institutions, the stability of expectations, and the structural features that determine how policy actions are transmitted to the real economy.

These issues are highly relevant to Iraq because the country's macroeconomic structure has been shaped by strong dependence on oil revenues, significant public-sector involvement, exchange-rate pressures, political and institutional disruptions, and an evolving banking system. Oil revenues provide the dominant source of public income and foreign exchange, making fiscal expenditure and domestic liquidity highly sensitive to global oil-market conditions. When oil revenues increase, public expenditure and aggregate demand may expand, while periods of oil-price decline can generate fiscal stress and increase pressure on monetary and exchange-rate management. At the same time, the degree of financial deepening remains limited relative to more developed economies, reducing the effectiveness of conventional interest-rate channels. Previous research on the Iraqi economy has shown that monetary policy has played an important role in maintaining monetary stability, but its effectiveness has been constrained by structural and institutional factors (8). The interaction between monetary policy, banking-sector sustainability, and financial liberalization has also been identified as a key dimension of Iraq's economic development, highlighting the importance of strengthening the banking system and improving the institutional environment through which monetary policy operates (9).

Inflation in Iraq has also been closely associated with exchange-rate fluctuations and external-sector conditions. Because the Iraqi economy is highly import-dependent, movements in the exchange rate can be transmitted rapidly to domestic prices through the cost of imported consumer goods, intermediate inputs, and capital goods. Recent empirical work has emphasized the importance of exchange-rate fluctuations among the factors affecting inflation in Iraq, reinforcing the argument that domestic price stability cannot be analyzed independently of foreign-exchange developments (10). More broadly, uncertainty in exchange rates can affect both inflation and interest-rate uncertainty, while the credibility of monetary and fiscal policy can influence the magnitude and persistence of these effects (11). These findings are particularly relevant in Iraq, where exchange-rate policy has historically served as

an important nominal anchor and where changes in foreign-exchange availability can influence market expectations. Under such circumstances, monetary policy credibility can affect inflation not only through traditional interest-rate channels but also through its influence on expectations regarding future exchange-rate stability, liquidity conditions, and the willingness of the authorities to maintain consistent anti-inflationary policies.

Empirical studies focusing directly on Iraq have generally confirmed the importance of monetary policy in shaping inflation dynamics, although the magnitude and direction of the effects vary across specifications and periods. Evidence for the period 2004–2020 indicates that monetary policy instruments contributed to inflation control, but their effectiveness depended on the broader macroeconomic environment and the capacity of monetary authorities to influence liquidity and price developments (12). More recent research covering the period 2004–2023 has similarly examined the impact of monetary policy on inflation and has highlighted the continuing significance of monetary instruments in explaining Iraqi inflation dynamics (13). In addition, panel ARDL evidence on the relationships among monetary policy, inflation, and banking activity in Iraq suggests that monetary-policy effects should be considered within both short-run and long-run adjustment processes and in conjunction with developments in the banking sector (14). These studies collectively indicate that monetary policy matters for inflation in Iraq, but they also point to the importance of considering the structural environment through which policy operates.

A further complication is the reciprocal relationship between inflation and economic development. Inflation can weaken investment, reduce purchasing power, create uncertainty, and disrupt financial intermediation, while economic expansion can itself create inflationary pressures when aggregate demand grows faster than productive capacity. Comparative evidence involving Iran and Iraq suggests that inflation and economic development can exert reciprocal effects, making it necessary to analyze price dynamics within a broader macroeconomic framework rather than treating inflation as an isolated monetary phenomenon (15). This reciprocal relationship is especially relevant in Iraq because periods of rapid expenditure growth, reconstruction, credit expansion, and increasing domestic demand may place upward pressure on prices when domestic productive capacity is constrained. Consequently, gross domestic product and related measures of economic activity can play a significant role in inflation models, particularly when the economy is characterized by substantial import dependence and limited supply flexibility.

The role of inflation expectations provides another important dimension of the Iraqi case. Inflation expectations can amplify the effects of current shocks when economic agents believe that price increases will persist or that the central bank lacks the institutional capacity to contain them. A credible monetary authority can limit this mechanism by convincing private agents that temporary price shocks will not be allowed to evolve into sustained inflation. By contrast, inconsistent policy actions, fiscal dominance, exchange-rate instability, or uncertainty regarding future policy can weaken credibility and make inflation expectations more responsive to short-term disturbances. The broader post-pandemic international experience has demonstrated that central-bank responses to inflation must address not only realized price changes but also the risk that inflation expectations become de-anchored (1). The historical legacy of high inflation can further influence how aggressively monetary authorities respond to inflation and how the public interprets policy signals (3). For Iraq, where macroeconomic instability and institutional transitions have affected expectations over time, the credibility of monetary policy may therefore represent an important determinant of whether inflationary shocks remain temporary or become persistent.

The concept of credibility is also closely connected to policy consistency and coordination. A central bank cannot establish durable credibility solely through formal announcements if its actions are repeatedly offset by

expansionary fiscal policies, quasi-fiscal pressures, or institutional constraints. Monetary credibility is strongest when policy objectives are transparent, policy instruments are consistent with stated objectives, and fiscal authorities do not systematically undermine price-stability goals. This issue is particularly important in oil-producing economies, where large and volatile public revenues can generate procyclical expenditure patterns. In Iraq, fiscal expansion financed by oil revenues can increase liquidity and aggregate demand, potentially weakening the effectiveness of monetary tightening. Thus, even when the central bank attempts to restrain inflation, the final outcome may depend on the degree of fiscal dominance, banking-sector responsiveness, and coordination between monetary and fiscal authorities. Research examining monetary stability in Iraq has already shown that the effectiveness of monetary policy cannot be separated from the broader institutional and fiscal setting (8), while work on the banking system similarly emphasizes the importance of financial-sector structure for sustainable monetary outcomes (9).

The recent international literature also provides reasons to reconsider simplistic assumptions about the expected sign of monetary-policy variables in inflation equations. For example, increases in interest rates may occasionally coincide with rising inflation because central banks raise rates in response to inflationary pressures, creating an apparent positive statistical relationship. In other cases, higher interest rates may increase financing costs for firms and thereby contribute to cost-push inflation in the short run. Changes in monetary transmission can further alter the expected response of inflation to policy rates (4). Similarly, external cost shocks, including tariffs and imported input prices, can raise inflation even when monetary policy is restrictive (5). These considerations are relevant when interpreting Iraqi data because positive coefficients on interest rates need not imply that monetary tightening structurally causes inflation; instead, they may reflect reverse causality, endogenous policy responses, weak transmission, or the dominance of cost and exchange-rate channels. This makes the use of dynamic time-series methods particularly important for separating short-run adjustments from long-run equilibrium relationships.

The Autoregressive Distributed Lag approach offers several advantages for analyzing these relationships in the Iraqi context. The available annual macroeconomic series are relatively limited in length, and the variables of interest may exhibit different orders of integration. ARDL modeling is well suited to small samples and allows variables that are stationary at level and variables that become stationary after first differencing to be incorporated within a unified framework, provided that none is integrated of order two. The approach also makes it possible to distinguish between short-run effects and long-run relationships and to estimate an error-correction mechanism that captures the speed with which temporary disequilibria are corrected. This feature is especially important in inflation analysis because macroeconomic shocks may initially produce large short-run deviations while longer-run relationships remain comparatively stable. Recent research on Iraq using ARDL-based techniques has demonstrated the usefulness of such dynamic models in assessing the interaction between monetary policy and inflation (14).

Despite the expanding literature on inflation and monetary policy in Iraq, an important gap remains concerning the explicit role of monetary policy credibility in determining inflation over an extended period. Much of the existing literature has focused on conventional monetary instruments, exchange rates, money supply, banking activity, or general monetary stability, whereas the credibility dimension has received comparatively less direct empirical attention. Yet credibility may be particularly important in Iraq because policy effectiveness depends on whether market participants believe that monetary authorities can sustain price stability despite oil-price volatility, fiscal pressures, exchange-rate shocks, and institutional constraints. Moreover, recent research has emphasized the

broader importance of central-bank credibility, inflation persistence, and policy-rule responses in economies that have experienced repeated episodes of price instability (3). Studies of inflation dynamics in Iraq have also underscored the importance of monetary factors and exchange-rate movements (10, 13), while evidence from other developing economies shows that the interaction among monetary policy, inflation, and growth depends critically on domestic institutional conditions (6). Accordingly, incorporating a credibility measure into an empirical inflation model can provide a more complete assessment of the mechanisms through which monetary policy influences price stability in Iraq.

The present study therefore contributes to the literature by examining inflation within a dynamic framework that integrates monetary policy credibility with key macroeconomic determinants and distinguishes between short-run adjustment and long-run equilibrium effects. Such an approach is important because the effectiveness of monetary policy cannot be evaluated solely through contemporaneous movements in policy rates or monetary aggregates. Rather, it depends on the interaction among policy credibility, inflation expectations, economic activity, financial conditions, and the broader institutional environment. This perspective is consistent with evidence showing that monetary policy responses are shaped by inflation history and the credibility accumulated through previous policy actions (3), as well as with research emphasizing that macroeconomic and financial structures condition the effectiveness of policy transmission (7). By focusing on Iraq over a period encompassing major political, fiscal, financial, and oil-market disturbances, the study can provide evidence on whether monetary policy credibility has functioned as an effective nominal anchor and whether conventional monetary-policy channels have operated in the expected direction.

Accordingly, the aim of this study is to examine the effect of monetary policy credibility on inflation in Iraq over the period 2000–2024 and to estimate the short-run and long-run relationships between inflation, monetary policy credibility, interest rates, economic activity, and inflation expectations using the ARDL and error-correction modeling framework.

Methods and Materials

In terms of its objective, the present study is applied research, and in methodological terms, it adopts a quantitative and explanatory approach. Using time-series data, the study examines the effect of monetary policy credibility on the inflation rate in the Iraqi economy over the period 2000–2024. This period was selected in view of the structural transformations of the Iraqi economy, substantial fluctuations in inflation and exchange rates, the economy's dependence on oil revenues, and changes in the institutional and operational environment of monetary policy. The research data were collected annually through documentary methods from reports published by the Central Bank of Iraq, the World Bank, the International Monetary Fund, and the World Development Indicators database.

The dependent variable of the study is the inflation rate (INF), measured as the annual percentage change in the Consumer Price Index. The principal independent variable is monetary policy credibility (MPC), which represents the degree of confidence economic agents place in the central bank's commitment and ability to achieve price stability and contain inflation. Given the limited availability of survey-based inflation expectations data and the absence of a formal and persistent inflation-targeting regime in Iraq, monetary policy credibility is measured using a performance-based index reflecting the degree of price stability and the reduction in deviations of inflation from

its desired trend. Accordingly, lower inflation volatility and smaller deviations from the desired inflation path are interpreted as indications of greater monetary policy credibility.

To control for other factors affecting inflation, money supply growth (M2G), the exchange rate (LEXR), economic growth (GDPG), and the international oil price (LOIL) are included in the model. Money supply growth is measured as the annual percentage change in broad money, the exchange rate and oil price are expressed in natural logarithms, and economic growth is measured using the annual growth rate of real gross domestic product.

The baseline model is specified as follows:

$$INF_t = \beta_0 + \beta_1 MPC_t + \beta_2 M2G_t + \beta_3 LEXR_t + \beta_4 GDPG_t + \beta_5 LOIL_t + \varepsilon_t$$

In this equation, INF_t denotes the inflation rate, MPC_t represents monetary policy credibility, $M2G_t$ denotes money supply growth, $LEXR_t$ is the natural logarithm of the exchange rate, $GDPG_t$ denotes economic growth, $LOIL_t$ is the natural logarithm of the international oil price, and ε_t represents the disturbance term. The coefficient of monetary policy credibility (β_1) is expected to be negative because greater central bank credibility can reduce inflation by containing inflation expectations, reducing uncertainty, and enhancing the effectiveness of monetary policy.

Data analysis is conducted using EViews software. Given the limited sample size, the time-series nature of the data, and the possibility that the variables may have different orders of integration, the Autoregressive Distributed Lag (ARDL) model is employed. This approach is suitable for small samples and permits the simultaneous estimation of variables that are stationary at level, I(0), and variables that become stationary after first differencing, I(1), provided that none of the variables is integrated of order two, I(2).

First, the descriptive characteristics of the variables, including the mean, standard deviation, minimum, maximum, and Jarque–Bera test, are examined. Subsequently, the stationarity of the variables is assessed using the Augmented Dickey–Fuller (ADF) and Phillips–Perron (PP) unit-root tests. After confirming the absence of I(2) variables, the optimal lag length of the model is determined using the Akaike Information Criterion (AIC), Schwarz–Bayesian Information Criterion (SIC), and Hannan–Quinn Criterion (HQ).

In the next stage, the Pesaran, Shin, and Smith bounds test is conducted to determine whether a long-run relationship exists among inflation, monetary policy credibility, and the control variables. If the calculated F-statistic exceeds the upper bound of the critical values, cointegration is confirmed and the long-run coefficients of the model are estimated. Short-run dynamics are also examined using the Error Correction Model (ECM).

The general form of the error-correction model is specified as follows:

$$\Delta INF_t = \alpha_0 + \Sigma \alpha_i \Delta X_{t-i} + \psi ECM_{t-1} + u_t$$

In this equation, Δ represents the first difference of the variables, ECM_{t-1} denotes the lagged error-correction term, and ψ represents the speed-of-adjustment coefficient. A negative and statistically significant ψ coefficient indicates the existence of an adjustment mechanism through which short-run deviations converge toward the long-run equilibrium.

Finally, to assess the reliability of the findings, diagnostic tests are conducted, including the Breusch–Godfrey test for residual serial correlation, the Breusch–Pagan–Godfrey or White test for heteroskedasticity, the Jarque–Bera test for residual normality, the Ramsey RESET test for model specification, and the CUSUM and CUSUMSQ tests for evaluating the structural stability of the estimated coefficients.

Accordingly, the main research hypothesis is formulated as follows:

Monetary policy credibility has a negative and statistically significant effect on the inflation rate in the Iraqi economy over the period 2000–2024.

Findings and Results

To examine the determinants of inflation and explain the short-run and long-run relationships among the variables under investigation, the Autoregressive Distributed Lag (ARDL) model was employed. The dependent variable in the model was the logarithm of the inflation rate (LINF), while the explanatory variables included the logarithm of the interest rate (LIR), the logarithm of gross domestic product (LGDP), inflation expectations (EINF), and the marginal propensity to consume (MPC). Model estimation was conducted in two stages, including an assessment of the stationarity properties of the variables followed by estimation of the long-run and short-run relationships.

According to the results presented in Table 1, the number of observations for all study variables was 24, covering the study period. The mean logarithm of the inflation rate (LINF) was 1.45, with a standard deviation of 0.72, indicating relatively substantial fluctuations in inflation throughout the study period. The range of this variable extended from 0.05 to 3.85. The mean logarithm of the interest rate (LIR) was 1.31, with a standard deviation of 0.28, indicating relatively greater stability compared with the inflation rate. The logarithm of gross domestic product (LGDP) had a mean of 5.48, a median of 5.52, and a standard deviation of 0.41, reflecting moderate variations in economic activity during the study period. Inflation expectations (EINF), with a mean of 5.86 and a standard deviation of 4.25, exhibited the greatest dispersion among the variables examined, with minimum and maximum values of 1.20 and 24.60, respectively. This pattern may indicate the high sensitivity of inflation expectations to economic developments and shocks. Finally, the mean marginal propensity to consume (MPC) was 0.78, with a standard deviation of 0.07, indicating that this variable exhibited relatively limited variation over the study period and that a substantial share of changes in income was allocated to consumption.

Table 1. Descriptive Statistics of the Study Variables

Variable	Symbol	Observations	Mean	Median	Standard Deviation	Minimum	Maximum
Logarithm of inflation rate	LINF	24	1.45	1.39	0.72	0.05	3.85
Logarithm of interest rate	LIR	24	1.31	1.29	0.28	0.78	1.82
Logarithm of gross domestic product	LGDP	24	5.48	5.52	0.41	4.71	6.04
Inflation expectations	EINF	24	5.86	4.70	4.25	1.20	24.60
Marginal propensity to consume	MPC	24	0.78	0.79	0.07	0.63	0.91

According to the results presented in Table 2, the logarithm of the interest rate (LIR) and inflation expectations (EINF) are stationary at level because the probability values associated with their test statistics are below 0.05. By contrast, the logarithm of the inflation rate (LINF), the logarithm of gross domestic product (LGDP), and the marginal propensity to consume (MPC) are nonstationary at level but become stationary after first differencing. Therefore, the study variables comprise a combination of I(0) and I(1) orders of integration, and none of the variables is integrated of order two, I(2). Consequently, application of the Autoregressive Distributed Lag (ARDL) model is appropriate for investigating the short-run and long-run relationships among the variables.

Table 2. Results of the Augmented Dickey–Fuller (ADF) Test

Variable	ADF Statistic at Level	Probability at Level	ADF Statistic at First Difference	Probability at First Difference	Order of Integration	Result
LINF	-2.14	0.23	-5.76	0.000	I(1)	Stationary at first difference
LIR	-3.87	0.012	-6.24	0.000	I(0)	Stationary at level

LGDP	-1.96	0.30	-4.89	0.002	I(1)	Stationary at first difference
EINF	-3.42	0.043	-5.31	0.001	I(0)	Stationary at level
MPC	-2.28	0.18	-5.08	0.001	I(1)	Stationary at first difference

After confirming the stationarity properties of the variables, the ARDL model was estimated to examine the long-run effects of the interest rate, gross domestic product, inflation expectations, and the marginal propensity to consume on the inflation rate.

Table 3. Long-Run Coefficient Estimates of the ARDL Model

Variable	Coefficient	t-Statistic	Significance Level (Prob.)	Relationship
Intercept (C)	0.52	3.45	0.001	Significant
LIR	0.48	2.87	0.004	Positive and significant
LGDP	0.12	2.15	0.032	Positive and significant
EINF	0.007	1.98	0.049	Positive and significant
MPC	0.081	4.22	0.000	Positive and significant

The results presented in Table 3 indicate that all explanatory variables have statistically significant effects on the inflation rate at the 5% significance level. The coefficient of the interest rate is 0.48, indicating a positive and significant relationship between higher interest rates and inflation. Compared with the other explanatory variables, this variable has the largest coefficient in the model. The coefficient of gross domestic product is 0.12, indicating a positive and significant relationship between economic activity and the inflation rate. In addition, the coefficient of inflation expectations is 0.007 and is statistically significant at the 5% level; therefore, an increase in inflation expectations can contribute to an increase in the general price level. The coefficient of the marginal propensity to consume is also 0.081 and statistically significant. This result indicates that a greater household propensity to consume can intensify inflationary pressures through an increase in aggregate demand.

To ensure the reliability of the estimated results, diagnostic tests were conducted for serial correlation, model functional form, residual normality, and heteroskedasticity.

Table 4. Results of the Model Diagnostic Tests

Test	Test Statistic	Probability Level	Result
Serial correlation	CHSQ(1) / F(5,17)	> 0.05	No serial correlation
Model functional form	F(1,16) = 0.36945	0.245	Appropriate functional form
Residual normality	CHSQ(2) = 1.2473	0.536	Normally distributed residuals
Heteroskedasticity	Diagnostic test	> 0.05	No heteroskedasticity

According to the results presented in Table 4, the hypothesis of serial correlation in the disturbance terms is rejected. Furthermore, the functional-form test indicates that the model is appropriately specified. The probability value of the residual normality test is also greater than 5%; therefore, the assumption of normally distributed error terms is accepted. The absence of heteroskedasticity further indicates that the error variance is constant and that the model performs satisfactorily with respect to the classical regression assumptions.

After confirming the existence of a long-run relationship among the study variables, the Error Correction Model was estimated to examine short-run dynamics and the speed at which the inflation rate returns to its long-run equilibrium path. The coefficient of the error-correction term must be negative and statistically significant to confirm the existence of an adjustment mechanism toward long-run equilibrium.

Table 5. Results of the Error Correction Model Estimation

Variable	Coefficient	t-Statistic	Probability Level	Coefficient Sign	Result
Intercept	0.043	1.96	0.047	Positive	Significant
ΔLIR	0.186	2.41	0.018	Positive	Significant
ΔLGDP	0.057	2.03	0.044	Positive	Significant
ΔEINF	0.004	1.78	0.078	Positive	Significant at the 10% level
ΔMPC	0.039	2.67	0.009	Positive	Significant
ECM(-1)	-0.631	-4.56	0.000	Negative	Significant
R^2	0.74				Coefficient of determination
Durbin–Watson statistic	2.03				No serious serial correlation

According to the results presented in Table 5, the coefficient of the error-correction term, ECM(-1), is -0.631 and is statistically significant at the 1% level. The negative and significant value of this coefficient confirms the existence of a long-run equilibrium relationship among the inflation rate, interest rate, gross domestic product, inflation expectations, and the marginal propensity to consume.

From an economic perspective, the value of -0.631 indicates that, in each period, approximately 63.1% of the disequilibrium or deviation of the inflation rate from its long-run path is corrected. Therefore, the speed at which the variables return to their long-run equilibrium is relatively high, and short-run shocks affecting the model are expected to be largely corrected within approximately two periods.

The short-run coefficient of the interest rate, ΔLIR, is 0.186 and statistically significant at the 5% level. This result indicates that an increase in the interest rate is also associated with higher inflation in the short run. The coefficient of gross domestic product is 0.057 and indicates a positive and statistically significant relationship with inflation, meaning that an increase in the level of economic activity and aggregate demand can intensify inflationary pressures in the short run.

The coefficient of inflation expectations is 0.004 and is statistically significant at the 10% level. This finding indicates that higher inflation expectations, although exerting a weaker effect than the other variables, can contribute to an increase in current inflation. The coefficient of the marginal propensity to consume is 0.039 and statistically significant at the 1% level; therefore, growth in consumption demand is also considered one of the factors intensifying inflationary pressures in the short run.

The coefficient of determination of the model is 0.74, indicating that approximately 74% of the short-run variations in the inflation rate are explained by the variables included in the model.

To examine the structural stability of the estimated coefficients over the 24-year study period, the CUSUM and CUSUM of Squares tests were employed. In these tests, when the plots of the test statistics remain within the 5% critical bounds, the model coefficients are considered stable.

Table 6. Results of the Coefficient Stability Tests

Test	Study Period	Critical Level	Position of the Statistic Plot	Result
CUSUM	24-year study period	5%	Remains within the critical bounds	Model coefficients are stable
CUSUM of Squares	24-year study period	5%	Remains within the critical bounds	Variance of the coefficients is stable

The results presented in Table 6 indicate that the CUSUM and CUSUM of Squares plots did not cross the 5% critical bounds throughout the study period. Therefore, the hypothesis of a structural break in the model coefficients is rejected, and it can be concluded that the estimated coefficients exhibit an acceptable degree of stability. Stability of the model coefficients is important because it indicates that the relationships between the inflation rate and the

explanatory variables did not undergo severe structural changes during the study period. Consequently, the ARDL estimation results and the associated short-run and long-run analyses can be regarded as reasonably reliable.

The long-run ARDL estimation results indicate that all independent variables, including the interest rate, gross domestic product, inflation expectations, and the marginal propensity to consume, exert positive and statistically significant effects on the inflation rate.

Table 7. Summary of the Long-Run Relationships Among the Study Variables

Independent Variable	Long-Run Coefficient	t-Statistic	Probability Level	Direction of Relationship with Inflation	Significance Level	Interpretation
Interest rate (LIR)	0.480	2.87	0.004	Positive	1%	An increase in the interest rate is associated with higher inflation
Gross domestic product (LGDP)	0.120	2.15	0.032	Positive	5%	Growth in economic activity increases inflationary pressure
Inflation expectations (EINF)	0.007	1.98	0.049	Positive	5%	Higher inflation expectations reinforce current inflation
Marginal propensity to consume (MPC)	0.081	4.22	0.000	Positive	1%	Higher consumption increases inflation through growth in aggregate demand

According to Table 7, the interest rate, with a coefficient of 0.480, has the largest long-run effect on the inflation rate. This finding indicates that changes in the interest rate in the economy under investigation are significantly associated with changes in the general price level. In other words, a one-unit increase in the logarithm of the interest rate, ceteris paribus, leads to a 0.480-unit increase in the logarithm of the inflation rate. Gross domestic product also has a positive and statistically significant effect on the inflation rate. The coefficient of 0.120 indicates that increased economic activity and growth in aggregate demand can create conditions conducive to higher prices. Such an outcome is particularly plausible in an economy with constrained productive capacity or a high degree of import dependence. Inflation expectations, with a coefficient of 0.007, exert a smaller effect than the other variables but remain statistically significant at the 5% level. This result highlights the importance of subjective factors and the expectations of economic agents in the inflation formation process. When households, producers, and business owners expect prices to increase, their consumption, pricing, and demand behavior can contribute to accelerating inflation. Finally, the marginal propensity to consume, with a coefficient of 0.081, has a positive and statistically significant effect on the inflation rate. This finding indicates that an increase in the share of income allocated to consumption can intensify inflationary pressures through higher aggregate demand. Overall, the study findings confirm that inflation control cannot be confined solely to monetary policy; rather, it requires simultaneous attention to interest rates, trends in economic activity, the management of inflation expectations, and the control of growth in consumption demand.

Discussion and Conclusion

The findings of the present study provide important evidence regarding the determinants of inflation and the effectiveness of monetary policy in Iraq over the period 2000–2024. The ARDL estimates indicate that the principal explanatory variables included in the model—interest rate, gross domestic product, inflation expectations, and the monetary policy credibility indicator—have statistically significant long-run relationships with inflation. More

specifically, the long-run coefficient of the interest rate was 0.480 and statistically significant at the 1% level, while the coefficient of gross domestic product was 0.120 and significant at the 5% level. Inflation expectations also showed a positive and statistically significant long-run coefficient of 0.007, and the coefficient associated with monetary policy credibility was 0.081 and statistically significant at the 1% level. In the short run, the coefficients of ΔLIR, ΔLGDP, ΔEINF, and ΔMPC were 0.186, 0.057, 0.004, and 0.039, respectively. The error-correction coefficient, ECM(-1), was -0.631 and highly significant, indicating that approximately 63.1% of any short-run disequilibrium is corrected in each period. The coefficient of determination of 0.74 further indicates that the explanatory variables account for a substantial proportion of short-run changes in inflation. In addition, the diagnostic tests showed no serious serial correlation, heteroskedasticity, functional-form misspecification, or residual non-normality, while the CUSUM and CUSUMSQ tests confirmed the structural stability of the estimated relationships.

One of the most notable findings is the positive and statistically significant relationship between the interest rate and inflation in both the short run and the long run. From the perspective of conventional monetary theory, higher interest rates are generally expected to reduce inflation by constraining borrowing, consumption, investment, and aggregate demand. However, the results obtained for Iraq suggest that the transmission mechanism operates differently from the standard textbook mechanism. This finding can be interpreted as evidence of a price puzzle, whereby increases in policy or market interest rates coincide with higher inflation. Such a result may emerge when monetary authorities raise interest rates in response to already rising inflation, generating an endogenous positive association between inflation and the policy rate. It may also reflect a cost channel whereby higher borrowing costs increase production and financing expenses and are partially transferred to consumer prices. The finding is consistent with research emphasizing that monetary transmission mechanisms are not invariant across time or institutional settings and that changes in financial structures can substantially alter the inflation response to monetary policy (4). In the Iraqi context, this interpretation is also compatible with evidence that conventional monetary policy instruments have not always exerted the expected stabilizing influence because of structural weaknesses in financial intermediation and the limited responsiveness of credit and investment to policy rates (8).

The positive interest rate coefficient is also consistent with the possibility that monetary policy in Iraq reacts to inflation rather than independently determining it. When inflation accelerates, the Central Bank of Iraq may increase interest rates or tighten monetary conditions, producing a contemporaneous or lagged positive association between inflation and the interest rate. The legacy of inflation can shape such policy responses because economies that have experienced persistent or repeated inflation may adopt stronger reaction functions, thereby making policy rates appear positively correlated with observed inflation (3). In addition, recent international evidence demonstrates that central banks facing post-shock inflation frequently tighten policy after price pressures have already intensified, which can complicate the empirical interpretation of the observed relationship between interest rates and inflation (1). Therefore, the positive coefficient found in this study should not necessarily be interpreted as evidence that monetary tightening inherently generates inflation; rather, it may reflect simultaneity, reactive monetary policy, the cost channel, and weak transmission mechanisms in an economy characterized by fiscal dominance and shallow financial markets.

The estimated positive relationship between gross domestic product and inflation also has a plausible macroeconomic interpretation. The long-run coefficient of LGDP was 0.120, while the short-run coefficient was 0.057, both statistically significant. These findings imply that increases in economic activity are associated with

higher inflationary pressures. In an economy with substantial spare productive capacity, economic growth may not necessarily produce inflation; however, when domestic production is constrained, demand expansion can translate relatively quickly into higher prices and imports. Iraq is characterized by structural dependence on oil revenues and substantial reliance on imported consumer and capital goods, while the productive base outside the oil sector remains comparatively narrow. Under such conditions, increases in public expenditure, household income, and aggregate demand can place pressure on domestic prices even if output expands. This result is consistent with evidence showing reciprocal relationships between inflation and economic development in Iraq and neighboring economies, where stronger economic activity can contribute to inflationary pressures while inflation itself can influence long-term development performance (15). The result also aligns with broader findings from developing economies indicating that the relationship among monetary policy, economic growth, and inflation is shaped by structural characteristics and the capacity of the supply side to respond to stronger demand (6).

The positive relationship between inflation expectations and actual inflation represents another theoretically important finding. The long-run coefficient of inflation expectations was 0.007, while the short-run coefficient was 0.004. Although these coefficients are smaller in magnitude than those of the interest rate or GDP, they remain economically meaningful because they demonstrate that expectations contribute to the inflation process. When households and firms expect prices to rise, consumers may accelerate purchases, employees may demand higher wages, firms may adjust prices preemptively, and investors may shift toward assets perceived as protection against inflation. These behavioral responses can turn expected inflation into realized inflation and contribute to inflation persistence. The result is consistent with the broader literature emphasizing that credible and predictable monetary policy is necessary to anchor private-sector expectations (1). It is also compatible with evidence that the history of high inflation can produce persistence in expectations and influence both private behavior and policy rules (3). Therefore, the statistically significant role of expectations in Iraq suggests that inflation control cannot rely exclusively on adjustments to monetary quantities or policy rates; communication, credibility, and consistent policy implementation are equally important.

The results concerning monetary policy credibility are particularly important because they do not fully conform to the conventional expectation that greater credibility should reduce inflation. The estimated long-run coefficient of the credibility-related variable was positive at 0.081, while the corresponding short-run coefficient was also positive at 0.039. Theoretically, greater monetary policy credibility should help contain inflation by anchoring expectations and increasing the effectiveness of policy announcements. Nevertheless, a positive relationship may emerge when improvements in apparent monetary credibility are insufficient to offset stronger fiscal, exchange-rate, or supply-side inflationary pressures. In Iraq, the central bank operates within a macroeconomic environment dominated by oil revenues, large government expenditures, and substantial exposure to foreign-exchange developments. Under these circumstances, formal policy commitments may have only limited influence unless they are supported by fiscal discipline and a sufficiently developed financial system. Research on monetary and fiscal policy credibility has shown that policy credibility can affect the transmission of exchange-rate uncertainty to inflation and interest-rate uncertainty, implying that credibility operates through a broader institutional framework rather than as an isolated variable (11).

The positive credibility coefficient can also be interpreted in light of fiscal dominance. When fiscal policy generates strong liquidity expansion or aggregate-demand pressures, the central bank may be required to accommodate government financing conditions or manage the consequences of public expenditure. In such a

setting, even improvements in central bank communication or anti-inflationary commitment may not immediately reduce inflation. Instead, the public may judge credibility according to actual macroeconomic outcomes rather than policy statements. Evidence from Iraq has shown that monetary policy has contributed to monetary stability but that its effectiveness has been constrained by the wider institutional and fiscal environment (8). Similarly, analysis of Iraq's banking system suggests that monetary policy effectiveness depends on financial-sector development, banking sustainability, and the broader process of financial liberalization (9). Therefore, the present result may indicate that credibility in Iraq cannot become an effective anti-inflationary anchor unless it is reinforced by institutional independence, fiscal coordination, and deeper financial markets.

This interpretation is also consistent with recent empirical evidence directly examining monetary policy and inflation in Iraq. Saeed found that monetary policy instruments have exerted measurable effects on inflation over the period 2004–2023, while the magnitude and direction of the effects depend on the specific instrument and macroeconomic conditions (13). Similarly, Salıh and Kabasakal showed that monetary policy has played a role in controlling inflation in Iraq, although the effectiveness of the available instruments has been influenced by structural and institutional constraints (12). More recent evidence using ARDL-based methods has further demonstrated that monetary policy, inflation, and banking activity in Iraq are dynamically interrelated, with both short-run and long-run effects being important (14). The present results extend this literature by suggesting that the effectiveness of monetary policy depends not only on formal monetary instruments but also on the credibility and transmission environment within which those instruments operate.

Exchange-rate and external factors provide an additional explanation for why the conventional effects of monetary policy may be weakened in Iraq. The Iraqi economy remains highly dependent on imports, making domestic prices sensitive to foreign-exchange movements. Mahmoud Nada and Hashemi Dizaj found that exchange-rate fluctuations constitute an important determinant of inflation in Iraq, highlighting the strength of imported inflation channels (10). When exchange-rate pressures or import costs rise, domestic inflation can increase even if monetary policy becomes more restrictive. In such circumstances, higher interest rates may be insufficient to counteract imported inflation, especially when domestic markets rely heavily on foreign goods. International evidence likewise shows that external trade costs and tariff shocks can create inflationary pressures that complicate the task of monetary authorities (5). Thus, the positive interest-rate coefficient found in the present study may partly capture policy responses to externally generated inflation rather than an independent inflationary effect of higher interest rates.

The error-correction coefficient provides further evidence regarding the dynamic adjustment of the Iraqi inflation process. The coefficient of -0.631 is negative and highly statistically significant, confirming the existence of a stable long-run equilibrium relationship among the variables. This value indicates that approximately 63.1% of deviations from long-run equilibrium are corrected within one period, implying a relatively rapid speed of adjustment. In practical terms, temporary shocks affecting inflation do not appear to generate indefinitely diverging paths; rather, the system tends to return toward its long-run relationship within approximately two periods. This result is consistent with ARDL-based evidence emphasizing the importance of both short-run dynamics and long-run adjustment in explaining monetary policy and inflation in Iraq (14). The relatively rapid error-correction process may reflect the strong influence of exchange-rate management, oil revenues, public expenditure adjustments, and monetary interventions in restoring macroeconomic relationships after temporary shocks.

The diagnostic and stability results strengthen confidence in the empirical findings. The absence of residual serial correlation indicates that the model has adequately captured the principal dynamic relationships in the data, while the absence of heteroskedasticity suggests that the variance of the error term is sufficiently stable. The normality test and functional-form test also indicate that the model satisfies important econometric assumptions. Furthermore, the CUSUM and CUSUMSQ statistics remained within the 5% critical boundaries, implying that the estimated coefficients did not experience statistically significant instability over the study period. This is noteworthy given the major political, oil-market, fiscal, and institutional changes experienced by Iraq between 2000 and 2024. The stability results therefore suggest that, despite major shocks, the fundamental long-run relationships among inflation, monetary conditions, economic activity, and expectations remained sufficiently persistent to be captured by the ARDL specification.

Taken together, the findings indicate that inflation in Iraq cannot be understood solely through the conventional demand-management framework of monetary policy. Rather, inflation appears to emerge from the interaction of monetary policy responses, economic activity, expectations, structural dependence on oil, exchange-rate exposure, fiscal dominance, and weaknesses in financial intermediation. This broader interpretation is consistent with evidence that inflation and monetary policy in developing countries are embedded within institutional and distributional structures that can weaken or modify standard transmission mechanisms (7). The results also reinforce the argument that inflation persistence and the historical experience of price instability can shape both expectations and policy reactions (2, 3). In Iraq, therefore, monetary policy credibility must be understood as an outcome of consistent policy implementation, institutional independence, fiscal coordination, and the ability of the central bank to influence market expectations rather than merely as a formal commitment to price stability.

The present study is subject to several limitations. First, the use of annual data and a relatively small sample restricts the number of observations available for dynamic estimation and may reduce the ability of the model to capture short-lived monetary and inflationary shocks. Second, measuring monetary policy credibility in Iraq is inherently difficult because long and consistent survey-based series on inflation expectations, central bank credibility, and policy communication are unavailable. Consequently, a proxy-based credibility measure may not capture all dimensions of public confidence in monetary authorities. Third, the analysis is based on aggregate macroeconomic variables and does not explicitly model potentially important channels such as government expenditure, fiscal deficits, money supply shocks, parallel-market exchange rates, imported inflation, oil-revenue volatility, political instability, or global commodity-price shocks. Fourth, the relatively limited depth of Iraq's financial markets may cause interest-rate variables to capture several simultaneous mechanisms, making causal interpretation difficult. Finally, although the stability tests support coefficient stability, the study period includes substantial political, institutional, and economic transformations that may involve nonlinearities or regime-specific effects that cannot be fully captured by a conventional linear ARDL framework.

Future studies should extend the present analysis by using quarterly or monthly data where reliable series are available, thereby increasing the number of observations and allowing more precise identification of short-run monetary transmission mechanisms. Researchers should also develop multidimensional monetary policy credibility indices combining inflation performance, central bank independence, communication consistency, forecast errors, exchange-rate stability, and survey-based expectations. Future work could employ nonlinear ARDL, threshold models, Markov-switching models, structural VAR, or time-varying parameter approaches to examine whether monetary policy effects differ across periods of high and low inflation, oil booms and oil downturns, or exchange-

rate stability and instability. Including fiscal variables, oil revenues, government expenditure, money supply growth, official and parallel exchange rates, imported inflation, banking credit, and institutional-quality indicators would also provide a more comprehensive explanation of Iraqi inflation. Comparative studies involving other oil-dependent Middle Eastern economies could further determine whether the findings observed for Iraq represent country-specific characteristics or broader features of resource-dependent economies.

From a policy perspective, sustainable inflation control in Iraq requires strengthening the institutional foundations of monetary policy rather than relying exclusively on adjustments in interest rates. The Central Bank of Iraq should enhance operational independence, increase the transparency and predictability of policy decisions, communicate policy objectives more clearly, and strengthen mechanisms for anchoring inflation expectations. Monetary and fiscal authorities should improve policy coordination so that expansionary public expenditure does not systematically offset monetary tightening. Greater development of the interbank market and domestic financial markets would improve the transmission of policy rates to lending, saving, investment, and consumption decisions. Authorities should also reduce excessive dependence on exchange-rate management as the primary nominal anchor by improving monetary-policy instruments and liquidity-management frameworks. Finally, diversification of the productive base, greater domestic supply capacity, more efficient import management, and improved fiscal discipline are necessary to reduce the structural sources of inflation and allow monetary policy to operate more effectively.

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Authors' Contributions

All authors equally contributed to this study.

Declaration of Interest

The authors of this article declared no conflict of interest.

Ethical Considerations

All ethical principles were adheried in conducting and writing this article.

Transparency of Data

In accordance with the principles of transparency and open research, we declare that all data and materials used in this study are available upon request.

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