



Permanent disinflationary effects on unemployment in a small open economy: Italy 1979–1995

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Abstract

The aim of this paper is to investigate the effects on the rate of unemployment of the disinflationary policies and other aggregate demand shocks which affected the Italian economy during the period 1979–1995. To this end, a structural cointegrated VAR model is built and the structural disturbances are recovered by imposing a set of short-run, contemporary restrictions. The results show that both short-run and long-run movements in unemployment are influenced by disturbances to aggregate demand, as well as by supply shocks. This evidence seems to be at odds with the predictions of “natural-rate” theories.

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1. Introduction

This paper shows that disinflationary policies and other adverse shocks to aggregate demand caused a permanent increase in Italian unemployment in the 1980s and early 1990s. These results are at odds with the prediction of “natural rate” theories, according to which tight monetary policies provoke only a rise in cyclical unemployment, since the long-run equilibrium unemployment is independent of monetary policy and aggregate demand. The picture which emerges from this paper is different: both short-run and long-run movements in unemployment are influenced by monetary policy and other shocks to aggregate demand, as well as by shocks on the supply side.

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These results support hysteresis theories (cf. Blanchard and Summers, 1986). In fact, a central prediction of these models is that a disinflationary process causes a rise in cyclical unemployment and this provokes a rise in the long-run trend, the so-called non-accelerating inflation rate of unemployment (NAIRU).

It is worth stressing that the possible presence of persistent aggregate demand shocks could also be accommodated within a conventional model with long-run monetary neutrality. After all, a building block of “natural rate” models rests on the idea that negative shocks on the demand side, in particular those originating from monetary policy tightening, might cause a temporary increase of unemployment in the presence of errors in expectations. Thus, persistent shocks on the demand side are compatible with a vertical long-run Phillips curve. Nevertheless, in this paper we find that, as far as the selected period in the Italian economy is concerned, the existence of a negative long-run equilibrium relation between inflation and unemployment cannot be rejected and hence a long-run non-vertical Phillips curve seems to characterize the Italian economy in the sample period considered.

It is important to point out that in 1979, the starting year of our investigation, the world economy was affected by three major events: (1) the Iranian revolution and the connected second oil shock which caused an increase both in unemployment and inflation in the industrialized countries; (2) Italy and some other European countries joined the fixed exchange rate mechanism of the European Monetary System (EMS); (3) The reaction of main central Banks to inflation consisted in a sharp increase of short-term interest rates. Hence, in 1979 we observe both a peak in inflation and the beginning of the disinflation era. In the early 1980s, as a consequence of disinflationary monetary policies, Italy and most OECD countries experienced recessions and the rate of unemployment rose to levels unknown since the Great Depression. Moreover, in Italy, as in other European countries, the increase in unemployment turned out to be strongly persistent. Furthermore, in the early 1990s, there was a new episode of tightening monetary conditions in Italy since exchange rate goals and anti-inflation policy induced another sharp increase in short-term interest rates. The recession of 1992–1993 followed and in the period 1991–1995 the rate of unemployment rose three percentage points to 12%.

In two recent papers Ball (1997, 1999) criticizes the prevailing explanation of the rise in European unemployment in the 1980s, founded on imperfections in the labor market. Such imperfections induced by a set of rules, regulations and labor market institutions, would make the labor market too inflexible. Ball argues that this “conventional wisdom” fails to consider the role of monetary policy and aggregate demand in the rise of long-run unemployment.

In this paper we try to address the questions raised by Ball and other authors by investigating the interactions among inflation, unemployment and monetary policy that characterize the Italian economy. To this end, a simple structural cointegrated VAR model, with quarterly data spanning the period 1979–1995, is built. We recover the structural shocks by imposing a set of identifying restrictions which aim to capture some features of a small open economy like Italy. Moreover, we avoid neutrality restrictions capable of obscuring potential permanent effects on unemployment of aggregate demand shocks and monetary policy intervention.

A widely held view maintains that in the 1980s and early 1990s, Germany, the country that was the anchor of the EMS, was the ‘conductor of the European orchestra’,¹ and hence identifying the monetary policy rule for a small open economy like Italy necessarily requires the consideration of

¹ ‘Conductor of the international orchestra’ is the famous expression that Keynes used in order to characterize the leading role of the UK during the classic gold standard and the asymmetrical working of this system.

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