

The Great Depression in Italy: Trade Restrictions and Real Wage Rigidities¹

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In Italy, as in many other countries, the years immediately after 1929 were characterized by a major slowdown in economic activity. We argue that the depth and duration of the crisis cannot be explained solely by productivity shocks. We present a model in which trade restrictions together with wage rigidities produce a significant slowdown in economic activity. The model is also consistent with evidence from sectoral disaggregated data. Our model predicts that trade restrictions can account for about one-half of the slowdown observed in the data while real wage rigidities can account for one-fourth of it. *Journal of Economic Literature* Classification Numbers: E30, F40, N24. © 2002 Elsevier Science

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1. INTRODUCTION

The economic recession experienced by many countries in the late 1920s and early 1930s—the Great Depression—also affected Italy. Despite the lower degree of industrial development in the Italian economy, the dynamics of the depression in Italy were not very different from those of more industrialized countries like England, France, and the United States. Although the fall in aggregate production was smaller, the contraction in industrial production was as severe as in more industrialized countries. More broadly, the key features of the Italian depression can be summarized as follows:

- (i) Persistent decline in international trade.
- (ii) Large fall in hours worked and production in the tradable sector, but negligible changes in the nontradable sector.
- (iii) Large fall in investment.
- (iv) Stability of the real wages.

A striking aspect of the Great Depression is that it involved many countries during the same time period. This consideration leads us to investigate possible mechanisms of international transmission. Among these mechanisms, the fall in international trade is the obvious candidate. In fact, all countries affected by the Great Depression also experienced a drastic and persistent fall in foreign trade.

Finding the causes of the fall in foreign trade is not difficult. Many countries, including Italy, implemented protectionist policies starting in the late 1920s. These policies took several forms, such as import tariffs, currency control, and quota restrictions. The consequence was a dramatic fall in international trade. Can this fall in international trade explain the Great Depression in Italy? In this paper we argue that the drop in international trade was indeed a major cause of the economic downturn in Italy in the 1930s, and that the slump was amplified by the rigidity of the *real* wages.

We develop an open-economy model with two sectors of production: the tradable sector and the nontradable sector. The tradable and nontradable productions are then combined to produce consumption and investment in the two sectors. A key property of the model is that foreign imports are an important input in the production of investment in the tradable sector. This assumption is based on the import structure of Italy in the 1920s and 1930s, where a significant share of nonfarm imports were investment goods for the industrial sector. This dependence on the import of investment goods—which derives from the lower development of the industrial sector in Italy—was an important mechanism of transmission of the international economic crisis in Italy. Using a calibrated version of the model, we show

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