Hysteresis and the European Unemployment Problem Revisited[1]

Jordi Galí (CREI, UPF and Barcelona GSE)

Summary: The unemployment rate in the euro area appears to have a strong unit root component. This is in stark contrast with U.S. unemployment. The paper examines possible sources of that nonstationarity through the lens of a New Keynesian model. Two competing hypothesis are assessed. Under the first hypothesis, the unit root is the result of exogenous permanent changes in the degree of workers' market power, as reflected in desired wage markups. The second hypothesis associates the unit root in the unemployment rate to wage setting by "insiders" who disregard the impact of their behavior on the employment prospects of those currently unemployed. That model leads to hysteresis in unemployment, with the latter variable displaying permanent changes in response to transitory shocks. The paper examines the empirical merits of both hypothesis, and some of their implications for monetary policy design.

[1] Work in progress, to be presented at the ECB Forum on Central Banking to be held in Sintra, May 21-23, 2015.