

Unemployment, Hysteresis and Transition

Miguel León-Ledesma

Department of Economics, University of Kent

Peter McAdam

DG Research, European Central Bank

April 2003

Abstract: In this paper, we quantify the degree of persistence in the unemployment rates of transition countries using a variety of methods benchmarked against the EU. In part of the paper, we work with the concept of linear ‘Hysteresis’ as described by the presence of unit roots in unemployment as in most empirical research on this area. Given that this is potentially a narrow definition, we also take into account the existence of structural breaks and nonlinear dynamics in unemployment. Finally, we examine whether CEECs’ unemployment presents features of multiple equilibria, that is, if it remains locked into a new level whenever some structural change or sufficiently large shock occur. Our findings show that, in general, we can reject the unit root hypothesis after controlling for structural changes and business cycle effects, but we can observe the presence of a high and low unemployment equilibria. The speed of adjustment is faster for CEECs than the EU, although CEECs tend to move more frequently between equilibria.

Keywords: Unemployment, Hysteresis, Unit Root, Transition, Markov Switching.

JEL: E24, C22, C23.

Correspondence: Miguel A. León-Ledesma, Department of Economics, Keynes College, University of Kent, Canterbury, Kent, CT2 7NP, UK. Phone: +00 + 44 (0)1227 823026. Fax: +00 +44 (0)1227 827850. Email: M.A.Leon-Ledesma@kent.ac.uk

Acknowledgements: Without implicating, we thank one anonymous ECB working paper referee, Andreas Beyer, Marco Bianchi, Alan Carruth, Giancarlo Corsetti, João Faria, Jérôme Henry, Andrew Hughes-Hallett, Annette Hochberger, Laura Piscitelli, Haris Psaradakis and, especially, Michael Ehrmann, Lutz Kilian, Ole Rummel and Jim Stock for helpful comments and discussions. The paper also benefited from comments of seminar participants at the *European Central Bank, University of Mainz*, the *Royal Economic Society* conference (Warwick, 2003) and the *Bank of Estonia*. McAdam is also honorary lecturer in macroeconomics at the University of Kent and a CEPR affiliate. The opinions expressed are not necessarily those of the ECB.