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INFLATION AND CURRENCY DEVALUATION IN THE SEVENTIES ITALIAN ECONOMY

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ABSTRACT

In the seventies of XX century, industrialized countries experimented high rates of inflation. Italy stood out for the magnitude and persistence of the rising price. Among other explanations, exchange rate policy is a candidate explanation of the inflationary spiral of the 1970s in Italy because domestic policy makers sought to achieve gains in competitiveness by devaluing the Lira. Basing on the theoretical underpinnings suggested by the literature about the Great Inflation, we built a simplified empirical framework to model the interactions between real exchange rates and inflation. We consider the Italian policy makers' strategy who conducted a differentiated exchange rate policy against the German Mark and the US Dollar to maximize the purported benefits of inflation. By using a battery of cointegration techniques, we find a stable long run relationship between real exchange rates and inflation. Moreover, we provide causal identification of this relationship in an error correction environment. Our main conclusion shows that real depreciations pushed inflation up in the epoch of managed flexible exchange rates, suggesting that competitive devaluation was not costless.

Classification JEL: *N14, E31, F31*
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