

Validity of Okun's Law: Empirical Evidence from Jordan

*Hassan Alamro, Qusay Al-dala'ien**

ABSTRACT

The objective of this paper is to measure the impact of economic growth on unemployment in the Jordanian economy in the short and in the long run during the period (1980-2011) by implementing the Okun's law. The relationship is measured by performing the gap model with Hodrick-Prescott filter (HP filter) to calculate the potential gross domestic product. To this end, an Autoregressive Distributed Lag Approach (ARDL), co-integration and the Error Correction Model (ECM) are employed to represent the short and the long term relationship. The results indicate that the economic growth has a weak negative short- and long-run effect on unemployment.

Keywords: Unemployment, Okun's Law, Gap Model, Autoregressive Distributed Lag Approach (ARDL), Co-integration, Error Correction Model.

INTRODUCTION

For long a time, unemployment has been one of the most prominent challenges facing Jordan's economy. Nevertheless, Jordan is considered a nation that has one of the highest rates of human development in comparison to other Arab countries. This development is evident from the high rate of education and the high standards of health services. According to the Department of Statistics in Jordan, the unemployment rate has been fluctuating between (12%-15%) in the last decade. The statistics also show that unemployment is likely to rise in the light of current political situation facing the neighboring Arab states. Unemployment in Jordan according to World Bank study prepared by (Razzaz and Iqbal, 2008) is caused by structural imbalances in the labor market and migrations from neighboring Arab countries, in addition to economic recessions that have accompanied some of the stages experienced by the Jordanian economy. Unemployment is generally associated with the status of the economic cycle. Unemployment intensifies in economic recessions, and in times of economic crises which results from internal factors related to the

procedures of labor and employment and/or from the imbalance between the outputs of education and the requirements of the labor market. It could also be caused by factors related to the external pressure system of the international economy. In contrast, during economic growth, unemployment will be reflected in the local economy in terms of growth and diversification, leading to the availability of many employment opportunities. Thus, it is obvious that the business and economic cycle has an essential role in the formation of the economy of contemporary societies and their labor market activities (Christiano and Eichenbaum, 1992).

To understand how the economic fluctuations influence unemployment, there should be an understanding of the relationship between unemployment and growth, which was presented by the American economist (Arthur Okun) in 1962. Okun discovered a negative relationship between changes in unemployment rates around the normal rates and changes in real GDP around the potential average, which is known as the law of (Okun's Law). Okun found that the high (low) GDP by 1% will lead to high (low) unemployment rates by 0.35%. This relationship has been confirmed by several studies conducted in many countries around the world, such as the study of the International Monetary Fund (IMF) that prepared by Ball (2012), in which he examined the existence of Okun's law on the OECD countries, this study concluded that the relation between unemployment and GDP as described in Okun's law is valid.

* Department of Economics, Business and Finance, Mutah University; Economic Researcher, Aqaba Special Economic Zone, Jordan. Received on 22/6/2014 and Accepted for Publication on 20/4/2015.

In this context, this study will attempt to find out the applicability of Okun's Law to the Jordanian economy, and to examine the relationship between unemployment and growth. The study will also estimate the rate of growth in real GDP which is essential to solve the problem of unemployment in Jordan.

Literature Review

Many studies emphasized the existence of the relationship between economic growth rates and the change of prevailing unemployment rates in the economy, the general trend of this relationship seems theoretically an the inverse relationship, high economic growth leads to increased employment rate and this means lower unemployment rate. But this relationship is not necessarily always true, because economic growth results from two sources. The first one is due to an increase of the labor productivity, which does not lead to the creation of additional jobs. The other source is associated with an increase of the amount of labor supply, which leads to the creation of additional jobs and thus reduces the rate of unemployment in the economy.

The contradictions in the perception of the relationship between growth and unemployment has led many economists to study this relationship, one of the most prominent studies is carried out by Arthur Okun (1962), which pointed to the existence of an inverse relationship between economic growth and unemployment rates in the United States for the period between 1947-1957. Okun has found high (or low) GDP by 3% will lead to high (or low) unemployment rates by 1%.

Many economists have tested the relationship that reached her Okun (Arthur Okun). In a study of Ting and Ling (2011) that aimed to examine the existence of Okun's relationship in terms of Malaysia economy. The relationship is measured by applying the first difference and gap model with Hodrick-Prescott filter (HP filter), furthered with Autogressive Distributed Lag (ARDL) to determine the co-integration between the variables and their causality. The results show the Okun's coefficient is -1.825 percent which is significant at 1 percent error.

Kreishan (2011) investigates the relationship between unemployment and economic growth in Jordan through the implementation of Okun's law, using annual data covering the period 1970-2008. The empirical results reveal that Okun's law cannot be confirmed for Jordan. Thus, it can be suggested that the lack of economic

growth does not explain the unemployment problem in Jordan.

Arshad (2010) used the gap equation and technique of Hodrick-Prescott filter (HP) for short run analysis to investigate the presence of Okun's (1962) relationship in the Swedish economy, whereas co-integration model and the error correction model is used to test the relationship between unemployment and GDP in the short and long run. The study shows that the Okun's law exists in the Swedish economy from the period 1993 quarter 1 to 2009 quarter 2, and found the Okun's coefficient is -2.22 percent. And also proves that there exist a long run and short run relationship between unemployment and GDP.

Villaverde and Maza (2007), investigated Okun's law for Spain and its seventeen regions over the period from 1980-2004. Based on its "gap" specification and using two different determining techniques, the results show that an inverse relationship between unemployment and output holds for most of the Spanish regions and for the whole country. However, the quantitative values of Okun's coefficients for these regions are quite different. In addition, the coefficients for each region varied across the two determining techniques. Even so, these coefficients are lower than those initially estimated by Okun and others. Stephan (2012) confirmed in the study presented by the existence of an inverse relationship between unemployment and growth in both Britain and France.

Javeid (2005) used annual time series data during the period 1981-2005 of Pakistan to find the association between unemployment rate and GDP growth which is presented empirically by Arthur Okun's in early 1960s. He applied difference version of Okun's law which is more appropriate to access results directly from empirical data, and used Engle-Granger co integration technique and Error Correction Mechanism (ECM) to find the short term behavior of GDP growth to its long run value. The results show negative relationship between unemployment rate and GDP growth and both variables have long run relation with each other. Moreover GDP growth will adjust more quickly towards equilibrium in the long run.

A study of Moosa (2008) showed non-applicability of these relations on many Arab countries, where unemployment rate does not intend to downward in the case of high economic growth in Algeria, Egypt, Morocco and Tunisia. Driouche (2013) confirmed the previous result, by adopting the Autoregressive

Distributed Lag approach-ARDL to test the relationship between unemployment and growth in Algeria, The results concluded to the absence of long-term equilibrium relationship between unemployment and economic growth in Algeria.

Studies confirm that in most developed countries the Okun's law can describe the reaction of unemployment to GDP fluctuations. In the other hand this relationship cannot confirmed in a wide spectrum of developing countries, for example Moosa (2008), estimated the Okun's law in four Arab countries and he found that output growth does not translate into employment gains, also many studies conducted in a developed countries like Hanusch (2012), Perman and Tavera (2005), Bhalotra (1998) and Roy (2004) came out with a results indicates that the Okun's low is not stable.

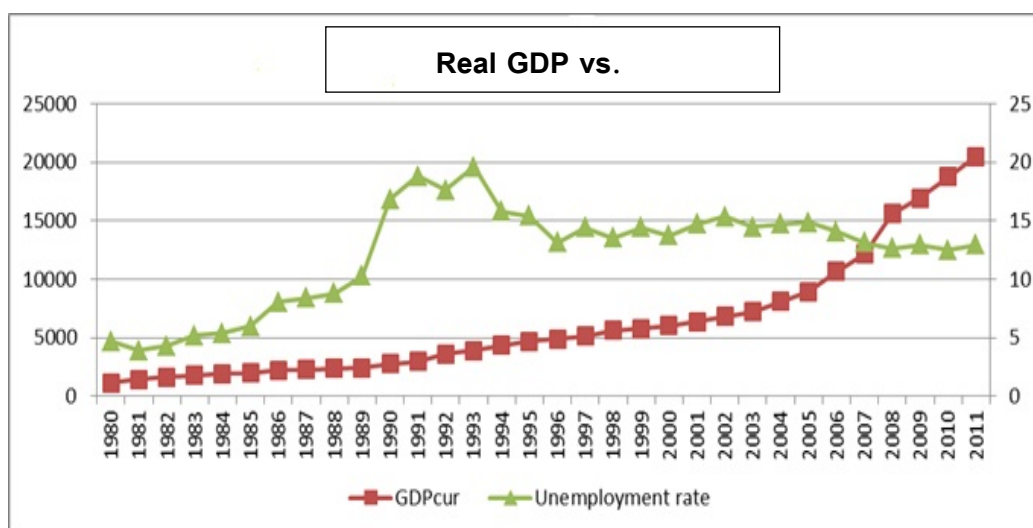
The evolution of unemployment in Jordan

The labor market in Jordan witnessed major fluctuation in the unemployment rate as a result of political and economic living situation in the region. As a result of the Arab-Israeli war in 1967 large numbers of Palestinian refugees settled in Jordan, creating imbalances in the labor market from the supply side of Jordan, which led to high unemployment rates in the

following years down to about 14% in 1972. However, Jordan began to recover from the effects of this shock in the mid-seventies during the oil boom and the growing number of migrant workforce to the Gulf States. As a result, the unemployment rate fell to reach 1.6% in 1976. As a result, bottleneck was resolved in the labor market in some Jordanian professions appeared, and this problem by foreign labor, and thus became Jordan the source and importer for labor at the same time in that period.

As a result of the repercussions of the Gulf War, the unemployment rate has begun to rise, which reached its highest range of 19.8% in 1993. In addition, the unemployment rate began to decline gradually as a result of adopted by Jordanian economy to contain the crisis and to achieve economic stability, where unemployment reached the approximately 12.5% in the year 2010.

Figure (1) shows that the behavior of the gross domestic product at current prices and unemployment in Jordan consistent with economic theory during the period (1994-2011). A gradual decline in unemployment during the period that accompanied rise of the GDP at current prices can be noted. On the contrary, it was the period that preceded the 1994 and can attribute it to shocks and crises witnessed by the Jordanian labor market during that period.



Resources: Department of Statistics (DOS) and the International Labor Organization (ILO).

Figure 1. Real GDP vs. unemployment rate

Okun's Formulation

The negative association between unemployment rate and GDP growth is first documented by Arthur Okun in

early 1960s. According to this empirical hypothesis growth slowdown causes unemployment rate to increase. This relationship is more statistical than structural

economic framework. Moreover there is no economic theory which explains the relationship between unemployment rate and economic growth, so the Okun's hypothesis can be used as a yardstick to measure the association between these two variables. Its simplicity makes this hypothesis easy to understand. Okun's law has different versions. These variations include: difference version, gap version, dynamic version and production function approach. Every method has its own pros and cons which are based on assumptions formulated by the researcher (Javeid, 2006).

- The Difference Version Approach: $(U_t - U_{t-1}) = \alpha + \beta (Y_t - Y_{t-1}) + \epsilon_t$

Where U_t = Unemployment rate in period t

Y_t = GDP growth in time period t

ϵ_t = Error term in time period t

This equation shows how the growth rate and unemployment rate change simultaneously, where

β is the Okun's coefficient having negative value. This means that an increase in growth rate would lead to a decrease in the unemployment level and a reduction in output is associated with rise in unemployment.

- The Gap Version Approach: $(U_t - U^*) = \beta (Y_t - Y^*) + \epsilon_t$

Where U^* = Natural rate of unemployment

Y^* = Potential output

ϵ_t = Error term in time period t

In the gap version approach, Okun focused on the gap between actual and potential output. He tried to identify the level of production under the condition of full employment. "Full of employment is a situation where everyone is able to get a job if they would like one". Okun considered an unemployment level low enough to produce maximum output without creating extra inflationary pressure. Okun concludes that a high rate of unemployment will be related with idle resources. In such scenario, the actual rate of output is expected to be below its potential and vice versa in case of low unemployment rate. Okun's gap version equation was based on the assumption that full employment occurs when unemployment is at 4%. On the basis of this assumption, Okun constructed a series of potential output for the US. Different level of potential output can be found with change in the assumptions of full employment.

- The Dynamic Version Approach: $\Delta U_t = \beta_0 + \beta_1 Y_t + \beta_2 Y_{t-1} + \beta_3 Y_{t-2} + \beta_4 \Delta U_{t-1} + \beta_5 \Delta U_{t-2}$

Where ΔU_{t-1} = First lag of unemployment rate

ΔU_{t-2} = Second lag of unemployment rate

ΔY_{t-1} = First lag of GDP growth

ΔY_{t-2} = Second lag of GDP growth

According to Okun's observations, current level of unemployment can be affected by both current and past output. Okun's analysis below indicates a relationship between past and current output on the one hand and current level of unemployment on the other.

- The Production-Function Version Approach: $Y = \alpha (k + c) + \beta (\gamma n + \delta h) + \tau$

Where Y = GDP growth in time period t

k = capital input

c = utilization rate

n = number of workers

h = number of hours they work

α & β = output elasticity's

γ & δ = contributions of the workers and weekly hours to the total labor input

τ = disembodied technology factor

Okun also considered another shortcoming that unemployment rate is also affected by non-utilization of resources in different sectors of society. In production process, in order to produce output there must be an optimum combination of inputs and according to economic framework that inputs are labor, capital and technology. But now a day most studies focus on labor force, working hours and technological advancement which really affects effects GDP growth. So according to Production-Function approach output is the function of capital, labor and technology.

Methodology

This study of Okun's law is based on the gap version. This study was the first study that discuss the Okun's formula as described by Arthur Okun, Kreishan (2011) used a simple relationship between GDP and Unemployment, however, this study measured the gap between GDP and Potential GDP and employed it to measure the impact of economic activity on employment level in Jordan. The argument for the gap version is that it provides a better explanation of unemployment and GDP relationship compared to the dynamic version. The gap version of Okun strives to show the difference between actual and potential output and assume that there will be maximum production level under full employment condition with no pressure of inflation. In regression framework or Okun's gap version equation, unemployment gap is taken as dependent and GDP gap is taken as independent, the equation can be written as:

$$(U_t - U_t^*) = \beta (Y_t - Y_t^*) + \epsilon_t$$

Where Y_t is actual real GDP level, Y_t^* is potential GDP level, U_t is the actual unemployment rate, U_t^* is the natural rate of unemployment. The right-hand side term represents the output gap, whereas $(U_t - U_t^*)$ captures the unemployment gap. In other words, the difference between the observed and potential real GDP captures the cyclical level of output; in the same vein, the difference between the observed and natural rate of unemployment represents the cyclical rate of unemployment. A major problem with this model is that there are no observable data on y_t^* and u_t^* so they have to be estimated, which means it is necessary to generate y and u trend series; a problem then arises concerning the choice of the determining method. Therefore, we have used the Hodrick-Prescott (HP) filter which is the most widely used model in empirical studies (Khan, 2013; tinigi,

2011; Villaverde, 2007; Huang, 2003).

The Hodrick-Prescott filter is a statistical tool used to figure out business pattern strategy to split the cyclical component of a time period from raw data. Usually this filter is checked to obtain a smoothed-curve reflection of a time period sequence of any raw data, which are more delicate to long-term than to short-term variations. The modification of the kindliness of the trend to short-term variations is obtained by changing a multiplier.

The general equation for Hodrick-Prescott filters (Hodrick, 1997):

$$\text{Min}(\sum_{t=1}^T (y_t - \tau_t)^2) + \lambda \sum_{t=2}^{T-1} [(\tau_t + 1 - \tau_t) - (\tau_t - \tau_{t-1})]^2$$

There are usually two terms in this filter. Firstly sum of squared deviations that penalizes the cyclical movement and secondly the multiple λ which penalizes the rate of the trend component.

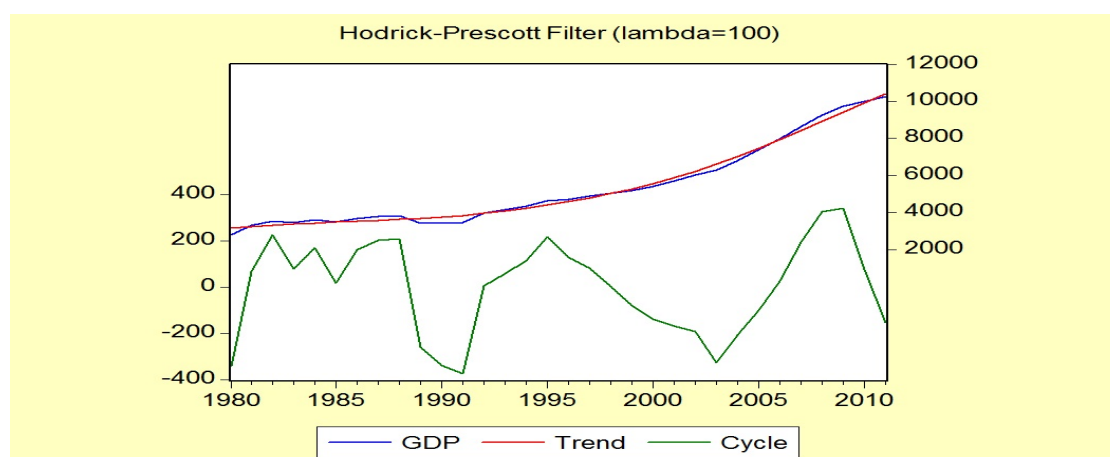


Figure 2. Potential GDP using Hodrick-Prescott Filter

As can be seen in the graph the lower the value of λ , lower is the penalty and vice versa.

The objective of this study is to employ co-integration and error-correction modeling to test the causal relationship between unemployment rate and the real GDP by using annually data from 1980 to 2011. We use a relatively new estimation technique, which is the bounds testing approach to co-integrate within an autoregressive distributive lag (ARDL) framework, as proposed by Pesaran and others (Pesaran and Pesaran, 1997; Pesaran and Shin, 1999; Pesaran et al., 2001).

The ARDL method yields consistent and robust results for the long-run and short-run relationship

between real GDP and unemployment. This approach does not involve pretesting variables, which means that the test for the existence of relationships between variables is applicable irrespective of whether the underlying repressors are purely $I(0)$, purely $I(1)$, or a mixture of both. In order to obtain robust results, we utilize the ARDL approach to establish the existence of long-run and short-run relationships. ARDL is extremely useful because it allows us to describe the existence of an equilibrium relationship in terms of long-run and short-run dynamics without losing long-run information. The ARDL approach consists of estimating the following equation:

$$\Delta UN_t = \alpha_0 + \sum_{i=1}^n \beta_i \Delta UN_{t-i} + \sum_{i=0}^n \gamma_i \Delta Y_{t-i} + \lambda_1 UN_{t-1} + \lambda_2 Y_{t-1} + \epsilon_t$$

The first part of the equation with β_i, γ_i represents the short-run dynamics of the model whereas the parameters λ_1, λ_2 represents the long-run relationship. The null hypothesis of the model is :

$$H_0 : \lambda_1 = \lambda_2 = 0 \text{ (there is no long-run relationship)}$$

$$H_1 : \lambda_1 \neq \lambda_2 \neq 0$$

We start by conducting a bounds test for the null hypothesis of no cointegration. The calculated F-statistic is compared with the critical value tabulated by Pesaran (1997) and Pesaran et al. (2001). If the test statistics exceeds the upper critical value, the null hypothesis of a no long-run relationship can be rejected regardless of whether the underlying order of integration of the variables is 0 or 1. Similarly, if the test statistic falls below a lower critical value, the null hypothesis is not rejected. However, if the test statistic falls between these two bounds, the result is inconclusive. When the order of integration of the variables is known and all the variables are I (1), the decision is made based on the upper bound. Similarly, if all the variables are I (0), then the decision is made based on the lower bound.

The ARDL methods estimates $(p+1)^k$ number of regressions in order to obtain the optimal lag length for each variable, where p is the maximum number of lags to be used and k is the number of variables in the equation.

In the second step, if there is evidence of a long-run relationship (cointegration) among the variables, the following long-run model:

$$UN_t = \alpha_1 + \sum_{i=1}^n \beta_i UN_{t-i} + \sum_{i=0}^n \gamma_i Y_{t-i} + \epsilon_t$$

If we find evidence of a long-run relationship, we then estimate the error correction model (ECM), which

indicates the speed of adjustment back to long-run equilibrium after a short-run disturbance. The standard ECM involves estimating the following equation.

$$\Delta UN_t = \alpha_2 + \delta_1 ECM_{t-1} + \sum_{i=1}^n \psi_i \Delta UN_{t-i} + \sum_{i=0}^n \rho_i \Delta Y_{t-i} + \epsilon_t$$

To ascertain the goodness of fit of the ARDL model, diagnostic and stability tests are conducted. The diagnostic test examines the serial correlation, functional form, normality, and heteroscedasticity associated with the model.

Empirical Results

This study used Microfit to find out if there are any relationship between economic activity and unemployment rate, Department of Statistics (DOS) and the International Labor Organization (ILO) is the source of data series from 1980 - 2011.

The first practice in applying any cointegration technique is to determine the degree of integration of each variable. For this reason, the Augmented Dickey-Fuller (ADF).

Before testing the co-integration relationship, a test of order of integration for each variable using the Augmented Dickey-Fuller (ADF) test is conducted. Even though the ARDL framework does not require the pre-testing of variables, the unit root test could help in determining whether or not the ARDL model should be used. The results of ADF are reported in table (1) with 95% critical value, the results suggest to reject the null hypothesis, which indicates that the series have no unit root, accordingly we accept that the two variables are stationary on level in both cases (with intercept only and with intercept and trend).

Table (1)

Unit root tests result

Unit Root Test using Augmented Dickey-fuller (ADF)					
Time Series	Level		1 ST Diff.		Deg. of Co-integration
	Intercept only *	Intercept and trend**	Intercept only *	Intercept and trend**	
UN	-55.98	-55.86	-55.75	-55.7	I(0)
GDP	-254.2	-251.5	-247.66	-245.6	I(0)

(*):95% critical value for the augmented Dickey-Fuller statistic = -2.9627.

(**):95% critical value for the augmented Dickey-Fuller statistic = -3.5671.

Co-integration Tests

In order to check the existence of a co-integration relationship among the variables, the bounds test, Pesaran

et al. (2001), was implemented, which is a three-step procedure. In the first step, we select a lag order on the basis of the Schwarz-Bayesian criteria (SBC) because the

computation of F-statistics for cointegration is very sensitive to lag length. In the second step of the ARDL analysis, we use F-test for the presence of long-run relationship. Table (2) reports the results of the calculated

F-statistic when each variable is considered as a dependent variable (normalized) in the OLS regression. The result show that the calculated F-statistics for model is exceeding.

Table (2)
Bound test results

F statistic	Critical values*		
5.44	Sig level	Lower bound	Upper bound
	1%	4.13	5.00
	5%	3.10	3.87

* The critical values are obtained from Pesaran et al. (2001), table CI (v).

The long-run relationship can be estimated as:

$$Un_t = 15.16 - 0.007y_t$$

(0.000) (0.000)

$R^2 = 0.82$, Adjusted $R^2 = 0.81$, DW = 1.81, F (Prob.) = 56.06 (0.00)

The above estimation represents the long-run

relationship between unemployment and GDP. The Okun coefficient also shown the immediate impact of changes in the GDP gap is negative and significant at the 1 percent level which means that 1 percent decrease in GDP will increase unemployment rate by 0.013 percent.

Table (3)
Short run results

	Coefficient	t-statistics	p-value
Intercept	6.53	4.55	0.000
Δy_t	-0.003	3.37	0.002
ECM (-1)	-0.43	4.44	0.000

Table (3) shows the results of the ARDL estimation in the short run, which appear to be similar result in the long run relationship. The weakness in the relationship between unemployment and GDP can be attributed to the fact that small size of Jordanian's economy and the public sector dominating role in employing labor force in Jordan, and slow response of labor market to the economic development, especially in gaining new skills and suitable training, also the emigrants labor to Jordan makes the impact of economic growth very week in terms of unemployment among Jordanian. This result is almost similar to Kreishan (2011) also to Moosa (2008), Moosa explained the absence of Okun's Law in his study by that unemployment in these countries is not cyclical but rather structural and/or frictional. Structural unemployment results from changes in the economy that is not matched by changes in education and training. This means that people are unemployed not because the economy is in a recession but because they do not have the skills to do the available jobs. Frictional unemployment, on the other

hand, results from failure to match job vacancies with the available job seekers. People may have the skills to do certain jobs but they are unaware of the availability of vacant positions that match their skills. Output growth cannot reduce these kinds as result. So the one can conclude that labor elasticity of demand will decrease toward economic growth.

The equilibrium correction coefficient (ECM (-1) estimated (-0.43) is highly significant (1%level) and has the correct sign. It shows that the system correct its last period disequilibrium (the speed of adjustment to restore equilibrium in the dynamic model) by approximately 43% a year; i.e. about 43% of disequilibria from the previous year's shock converge back to the long-run equilibrium in the current year.

The goodness of fit of these models is relatively high, and the overall models are significant. The regression specifications fit well and pass all diagnostic tests against serial correlation, autoregressive

Conditional heteroscedasticity, non-normal residual,

heterosedasticity, and incorrect functional form. Table (4) reports the diagnostic tests.

Table (4)
Diagnostic tests

ARCH 1-1 test	F(1,22)= 0.868 [0.351]
Normality test	χ^2 (2)= 1.26 [0.53]
Serial correlation test	F(1,27)= 0.214 [0.644]
RESET test	F(1,22)= 0.161 [0.688]

Conclusion

Okun's law came from noticing that the more labor used in production, the more output will result in the economy. This idea was the motive behind this relationship. In this study we used a reverse relationship represents how changes in the unemployment rate behave under the influence of output change. The increasing output growth rate leads to decreasing unemployment rate, and vice versa.

One of the characteristics of the Labor market in Jordan was its instability over the past three decades. The labor market suffered from political instability, and bad economic policy led to disturbances in the labor market and has contributed to high rates of unemployment which reached almost 19% in 1993.

By applying the Gap Model the results slightly suggest that the Jordanian economy is Okun's type relationship, which means that the unemployment rate is weakly affected by the growth rate during the period (1980-2011). The results reveal that when the Jordanian economy rise with 1% rate the unemployment rate will drop by 0.007% on the long term, the results were approximately the same in the short term.

This result can be explained by the rigidity of the

Jordanian labor market. The government sector has a major share of the labor market and the education output does not fit to the labor market needs and the emigration rate prevents a strong response of labor market to the economic growth.

Because of the weak relationship between unemployment and economic growth, Policy makers in Jordan should implement economic policies that promotes both economic growth and employment, concentrating the efforts on economic growth will not necessarily reduce the unemployment rate in Jordan at the same speed. Also, we should focus on small and micro project to create more jobs specifically for women. Private sector also has an essential role in new job creation through investing in new areas and government should help the private sector specially in Labor-intensive projects through implementing proper fiscal and monetary policy.

Labor force policy should work on labor force distribution to achieve optimal employment of human resources and directing education output towards fulfilling the needs of the Jordanian labor market this will reduce the gap between education output and the labor market.

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صلاحية قانون أوكن: أدلة تجريبية من الأردن

حسن العمرو، قصي الضلاعين*

ملخص

هدفت هذه الورقة البحثية إلى قياس أثر النمو الاقتصادي في البطالة في الأردن، على المدى القصير وال المدى الطويل ضمن الفترة ما بين (1980 - 2011) من خلال تطبيق قانون أوكن. وقد تم قياس العلاقة من خلال تطبيق نموذج الفجوة، كما تم استخدام مرشح هودريك - بريسكوت لتقدير الناتج المحلي الإجمالي الكامن. وللوصول لهذه النتيجة تم تطبيق منهجية الانحدار الذاتي ذي التباطؤ الموزع، ونموذج تصحيح الخطأ لتمثيل العلاقة على المدى القصير والطويل. وأشارت النتائج إلى أن العلاقة ما بين النمو الاقتصادي والبطالة عكسية إلا إنها ضعيفة على المديين القصير والطويل.

الكلمات الدالة: البطالة، قانون أوكن، نموذج الفجوة، التكامل المشترك، نموذج تصحيح الخطأ.

* باحث اقتصادي، قسم اقتصاديات المال والأعمال، سلطة منطقة العقبة الاقتصادية الخاصة، الأردن. تاريخ استلام البحث 2014/6/22، وتاريخ قبوله 2015/4/20.