JEL Classification Numbers:
E24, F13, F42

Summary of
WP/95/20

"Trade Liberalization and Unemployment"
by Pierre-Richard Agénor and Joshua Aizenman

Increasing attention is being devoted to the role of labor markets in the design of macroeconomic and structural adjustment programs. This paper attempts to provide a theoretical framework for understanding the impact of labor market imperfections on the short- and medium-run effects of trade liberalization. The analysis considers a small open economy producing exportable and nontradable goods, with imperfect labor mobility across sectors. Firms in the export sector face significant labor turnover costs, with the quit rate depending on the wage differential across sectors. In equilibrium, wages in the export sector are shown to be positively related to the market-clearing wage in the nontraded goods sector. Private consumption expenditure depends linearly on "expected" disposable income, with the weight attached to current income (as opposed to permanent income) being positively related to the intensity of liquidity constraints faced by households.

A reduction in tariffs, coupled with an increase in lump-sum taxes to equilibrate the government budget, is shown to lower wages in all production sectors in the short and the medium run but has an ambiguous effect on unemployment in the export sector. Although employment and production of exportables expand in the medium run, the steady-state unemployment rate may rise or fall depending on whether the elasticity of wages in the export sector with respect to wages in the nontraded goods sector is lower or greater than unity. On impact, trade reform may lead to a reduction in the unemployment rate if (as a result of tight liquidity constraints) household consumption is a function mostly of current income. In addition to formal derivations, the paper provides a detailed intuitive discussion of the role of the relative wage elasticity and imperfect mobility of labor in determining the direction of the short- and medium-run effects of trade liberalization on employment and unemployment.

The analytical framework presented in the paper focuses on the short- and medium-term effects of trade reform programs that do not modify the set of production activities carried out in the economy. However, it is emphasized that a drastic trade liberalization package (or a package embedded in a comprehensive restructuring program) may, over the long term, encourage the formation of new activities, changing over time the sectoral composition of output. Under such conditions, even if trade liberalization entails significant adjustment costs in the short or the medium term, it may still be highly beneficial in the long run.