

Sustaining Imperfectly Credible Trade Liberalization:  
Do the Rate of Tariff Reduction and the Degree of Labor Mobility Matter?

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**Abstract:**

Imperfectly credible trade liberalization can lead to balance of payment deterioration and a subsequent reversal in the reform. In effect, if the private sector expects trade liberalization to be reversed, consumers will binge on imports before the expected rise in the tariff rate, as was the case in Mexico (1988), Kenya (1978 and 1980), and many other developing countries in recent years. The consumers' speculative behavior significantly reduces the central bank's foreign exchange reserves. If the reserves fall below some critical level, the government will likely abort the trade liberalization. Thus, expectations of policy reversal can be self-fulfilling. Accordingly, I develop a continuous-time, two-sector general equilibrium model with money in the utility function in order to examine whether the likelihood of policy reversal depends on the rate of tariff reduction or the degree of labor mobility. The analysis shows not only that transitory unemployment increases the likelihood of policy reversal, but also that a gradual reduction in the tariff rate can extend the life of the liberalization episode. However, gradual tariff reduction does not necessarily increase the likelihood of sustained liberalization.