Free Trade Agreement and Economic Multiplier A Theoretical Simplification

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Abstract - Free-Trade Agreements (FTAs) are normally made between two countries. Many Governments throughout the world have either signed free-trade agreements or are negotiating or contemplating new bilateral and multilateral free- trade and investment, because in today's globalised world, no country can be fully insulated from what happens in the global economy. As a country is increasingly integrated into the world, it cannot neglect or reject the development abroad. The economic integration with the world economy is mainly through foreign trade, i.e., imports and exports of visible and invisible items. This process of trade has a strong positive and negative multiplier impact on the Balance of Payment (BoP) position and the domestic economy, which needs corrective measures for sustainable inclusive growth of our economy.

Keywords: Balance of Payment – Fiscal Deficit – Economic Multiplier – Marginal propensity to consume and Save – Rupee Exchange Ratio – Inflation – Tax-Treaty.

I. INTRODUCTION

No country in today's globalised world can be fully insulated from what happens in the global economy and India is no exception to this rule. As the country is increasingly integrated into the world, it cannot remain impervious to developments aboard. The unfolding of US and Euro Zone Crisis and uncertainty surrounding the global economy have impacted the Indian economy causing drop in growth, higher Current Account Deficit (CAD) and declining capital inflows. The transmissions of the crisis have been mainly through the Balance Of Payment (BOP) channel due to the unscientific and Core competency lacked Free Trade Agreement (FTA). Export growth has decelerated while imports have remained high, partly because of continued high international oil price.

The literature analyzing the economics of free trade is extremely rich with extensive work having been done on the theoreticaland empirical effects.Though it creates winners and losers, the broad consensus among members of the economic profession argued that free trade is large and unambiguous net gain for society.

According to main stream economic theory, the selective application of free trade agreements to some countries and tariff on others can sometimes lead to economic inefficiency through the process of trade diversion.

It is economically efficient to produce a good in the country that can make it for the lowest cost, but this does not always take place if a high cost producer has a free trade agreement while the low cost producer faces a high tariff. Applying free trade to high cost producer can lead to trade diversion and a net economics loss. This is why many economists place such high importance on negotiations for global tariff reductions, such as the DohaRoud.

Free Trade Agreement

Free Trade Agreements are normally made between two countries. Many Govt. throughout the world have either signed Free Trade agreements or are negotiating or contemplating new bilateralfree trade and investment. However, there are two types of free trade agreements ie; bilateral and multilateral.

India looks at Regional Trading Arrangements (RTAs) on 'building blocks' towards the overall objective of trade liberations. Therefore it is participating in a number of RTAs which include structures such as Free Trade Agreements (FTA), Preferential Trade Agreements (PTA) and comprehensive economic co-operation agreements.

Free Trade Agreements (FTA)

A free Trade Agreement among two countries or group of countries agrees to abolish quotas, tariff, and preferences on most of the goods (if not all) between them.

Countries choose an FTA if their economical structures are complementary not competitive India enjoys FTA till date with countries like Sri Lanka, Thailand.

Trade Agreements

It is a bilateral or multilateral treaty or any other enforceable compact which commits two or more countries to specified terms of commerce, most of time involving mutually beneficial concessions.

Frame work Agreements

A frame work agreements is one which sets the period for future substantive liberalization by defining the scope and provisions of orientation for some new areas of discussions.

Preferential agreements

This trade agreement gives preferential right of entry to only certain products. It is done by dropping tariff but it does not abolish them completely PTA is established through trade pact and it is the weakest form of economic integration.

A free trade area is a trade block whose member countries have signed free trade agreements (FTA) which eliminates tariff, import quotas and preferences on most goods and services traded between them. If people are also free to move between the countries in addition to FTA, it would also be considered an open border. It can be considered as the second stage of economic integration.

Countries choose this kind of economic integration if their economical structures are complementary. If their economical structures are competitive it is likely there will be no incentive for a FTA or only selected areas of goods and services will be covered to fulfill the economic interests between two signatories of FTA.

Members of a free trade area do not have a common external tariff, which means they have different quotas, and customs as well as other policies with respect to non-members to aviod tariff evasion through re-exportation the countries use the system of certification of origin most commonly called rules of origin, where there is a requirement for the minimum extent of local material inputs and local transformations adding value to the goods. Only goods that meet these requirements are entitled to the special treatment envisioned by the free trade area provisions.

Positive Multiplier

Positive economic multiplier is an economic situation which states that every time if there is an injection of new demand into the circular flow of income, there is likely to be a multiplier effect. This is because an injection of extra income leads to more spending, which creates more income and so on. The multiplier effect refers to the increase in final income arising from any new injections of spending.

The size of the multiplier depends upon households marginal decisions to spends, called Marginal Propensity to Consume (MPC) or to save called marginal propensity to save (MPS). It is important to remember that when income is spent, this spending because someone else's income and so on. Marginal propensities show the proportion of extra income allocated to particular activities such as investments saving by households and spending an imports from aboard. The multiplier concepts can be used any situations where there is a new injection into an economy. Examples of such injection include:

1. Increase in Govt. spending through budget and others.
2. When there is an increase in exports to aboard.
3. When there is a reduction in interest rates or taxes or when exchange rate falls.

For example if 80% if all new income in a given period of time is spent an products, the marginal propensity to consume would be 80/100 which is 0.8.

The following general formula to calculate the multiplier uses marginal propensityas follows:-

$$1/_{1}\ \_\text{MPC}$$

Hence, if consumes spend 0.8 and save 0.2 if every Re. 1 of extra income, the multiplier will be:

$$1/_{1} - 0.8$$

$$1/_{0.2}=5$$

Hence, the multiplier is 5, which means that every Re. 1 of new income generates Rs. 5 of extra income and the pace of economic growth thus can be increased.

The above multiplier effect is possible through an injection of additional income through more export (Demand for domestic goods increase) with an export oriented Free Trade Agreement or policy measures.

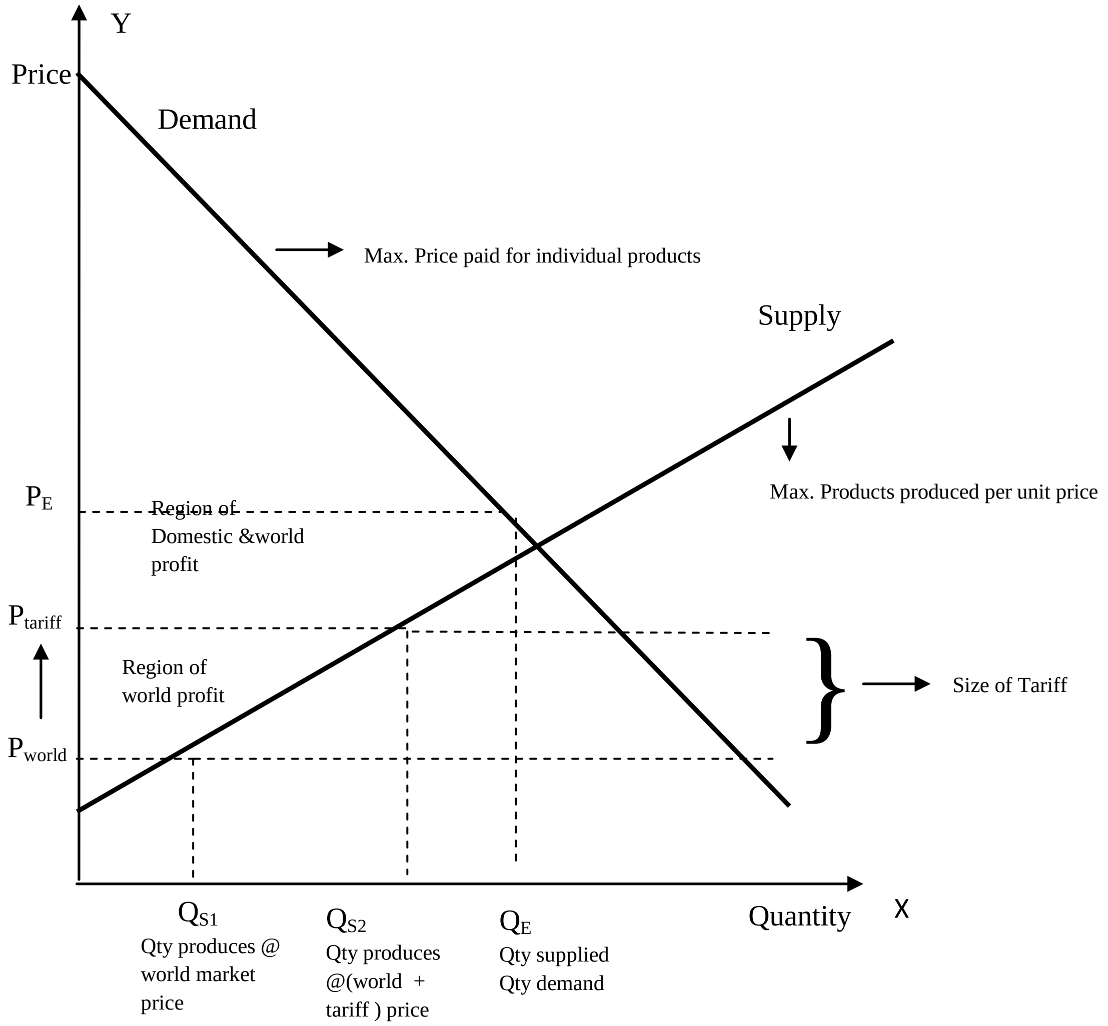
Moreover, Economists who advocated free trade Agreement believed trade was the reason why certain civilizations or nations prospered economically. Adam smith, the factor of economics, pointed to increased trading as being a reason for example not only for flourishing cultures but also for the economic prosperity and well being of nations.

A simple way to understand the proposed benefits of the free trade are through David Ricardo's theory of comparative advantage and by analyzing the impact of a tariff or import quota. An economic analysis using the law of demand and supply and the economic effects of a tax can be used to show the theoretical benefits and disadvantages of Free Trade.

This graph demonstrates the benefit of tariffs to a domestic industry. Assume that a country wants to protect a domestic industry that is only able to produce and sell a product at the price 'P_{tariff}'. Since there are other countries that are exporting the same product at price 'P_{world}', the domestic industry is threatened to go out of business should products be imported into their country without a tariff. This graph also shows that as long as 'P_{tariff}' does not fall above the intersection of the supply and Demand lines, then equilibrium can be reached in which there are no shortage of demand or excesses of supply and so domestic industry can produce and sell the product to the same degree as producers in any other country.

In this case the higher price would not cause domestic production to increase from Q_{s1} to Q_{s2} since it has already been assumed that domestic industry cannot afford to enter the product market below price ‘P_{tariff}’ as the world economy has for price ‘P_{world}’.

The effect of the tariff would limit imports and would create a higher demand for domestic products (Q_{s2}-Q_{s1}) but have no effect on consumer price, since the graph shows that all quantities to the left of the intersection of demand and supply curves, consumers will buy whatever products enter into the markets. As increasing product sale allow more producers to enter the market and the quantity of imported +domestic product with in the country approaches Q_E then the tariff can be phased out since the market will be in equilibrium (E) and the P_E market price will be enough for domestic producers to stay in business. FTA also provides benefits like reduction in tariff, greater co-ordination and co-operation among member countries, preferred access to input market at competitive price. Benefits are to access Product market, improved financial relations and core competency improvement.



Negative Multiplier or Reverse Multiplier

So far we have discussed about the benefit of Free trade agreements with special reference to positive multiplier in the economy through increased export (ie; Demand for domestic product increase). Now we have to analyze the opposite of the earlier situation called Negative Multiplier or Reverse Multiplier.

As well as calculating the multiplier in terms of how extra income gets spent, we can also measure the multiplier in terms of how much of the extra income goes in saving and other withdrawal from the circular flow of income.

A full open economy has all sectors and therefore, three withdrawals such as saving, taxation, and imports. This is indicated by marginal propensity to save (MPs) plus the extra income going to the Govt. the marginal tax rate (mtr) plus the amount going abroad the marginal propensity to import (MPm).

By adding up all the withdrawals we get the propensity to withdraw (Mpw). The multiplier can be calculated by the following equation.

$$1/_1 - \mathrm{MPw}$$

Thus a withdrawal of income from the circular flow will lead to a downward multiplier effect. Therefore whenever there is an increased withdrawal especially through increased imports along with a rise in saving, taxation , there is a potential reverse multiplier effect on the rest of the economy which may lead to serious social and economic consequences in the country like low growth, un employment etc.

More over an analysis of the recent statistics on our balance of payment position clearly shows that,it has been badly affecting and lead to the reverse multiplier effect in the economy. That means, since the last five years from 2006-2007 to 2010-11 except 2008-09 we have been running with an adverse balance of Payment position. It was Rs. 36606 US million dollars, -92164, 20080, -13441, -13050 in 2006-07, 07-08, 08-09, 09-10, 10-11 respectively. The reverse multiplier effect will be more sivere when imports are high along with decline in domestic investment as it was clear due to the 2008 economic crisis our foreign institutional investments flows have declined straining the capital amount and rupee exchange ratio that touched an all time low of Rs. 54.23 per US Dollar on 15 December 2011. (India budget.nic.in)

II. CONCLUSION

Thus, the multiplier effect is symmetric and works both the ways. It is a double-edged weapon. Therefore it is the right time to evaluate our Free Trade Agreements strategies and policies in the light of the impact on multiplier and Reverse multiplier so that we could be able to suitably restructure it in an inclusive growth perspective i.e.; in such a way to attract more investment, increase the rate of growth. The central government recently released Five Year Plan Coordination Guidelines on the basis of the recommendations of the Kelker Committee. It clearly shows the steps for the reduction of fiscal deficit, and schems for the restructuring of tax regime. It also expects that the monetary polcy of RBI wil take this aspect into consideration for the designing of credit policy. Through strong fiscal and monetary policies, the economy could be able to maintaine the trust and confidence of investors which would accelerate the economic gowth and control the inflationery presures in the economy.This helps to reduce the bad impact of economic multiplier

The Central government proposes to maintain the fiscal deficit at 5.3% of GDP; it was 5.8% in the previous year. Now they plan to maintain it at 5.1% then to 4.8% in 2013-14. To realize it they should curtail the unnecessary expenditure especially the imports and reform the existing tax structure including the international taxation treaty if necessary in order to achieve the dream of sustainable inclusive growth and a strong leader of the world economy in the future.

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