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Reviews on the Impacts Free Trade Agreements

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Abstract: Formation of free trade agreements are a part of economic globalisation. Various developed and underdeveloped countries started to liberalize their trade policies through free trade agreements. This has caused various impacts on its participating countries and non-member countries. This paper is a review on the impacts of free trade agreements in the economies. Impacts are broadly classified into macro level impacts and firm level impacts. It has been observed that free trade agreements create positive as well as negative results. These can vary based on the nature of FTAs and type of economy.

Keywords: Free Trade Agreements; Trade creation; Trade Diversion; Firm level impacts

FREE TRADE AGREEMENTS

Free trade policies attracted many economists since the time of Adam Smith. When the countries remove their trade barriers, countries get benefitted through various ways. Overall development of countries through low-priced quality goods, increased competition and improved efficiency is expected through these policies. Countries started to introduce trade liberalisation policies to reap the benefits of free trade. Free trade agreements are a part of this. Free trade agreements are treaties between countries to remove or reduce tariff barriers in international trade. Free trade agreements are generally termed as regional trade agreements (RTAs). Based on the intensity of integration, we have different kinds of RTAs such as Preferential Trade Agreements (PTAs), Free Trade Agreements (FTAs), Customs Union, Common market and Economic Union.

Free Trade Agreement become a major economic policy of countries since 1990s. Most of the economies shifted their attention towards free trade policies from old protectionist policies such as import substitution, non-tariff barriers, subsidies etc which are considered to be the antithesis of free trade. This change in the trade policy is an outcome of economic globalisation which is proliferating in the recent decades. Countries engage in FTAs from the expectation of its trade benefits and welfare implications. As of 1 December 2022, 355 RTAs were in force. These correspond to 582 notifications from WTO members, counting goods, services and accessions separately (WTO 2023). The benefits of FTAs are diverse for each participating country. The increasing trend of FTAs between countries across the globe is a call for the study on these agreements. Diverse nature of FTAs like North-South, South-South trade agreements necessitates this.

We can see a number of studies on the impacts of Free trade agreements in the recent past which focuses on the aftermath of FTA formation. They have identified various consequences of regional integration through free trade agreements. These are the inspiration to analyse the impacts of free trade agreements through this paper.

WHAT ARE THE IMPACTS OF THE FORMATION OF FREE TRADE AGREEMENTS?

Countries form free trade agreements from the expectation of export benefits and other economic benefits. These agreements have various kinds of impacts in member countries and non-member countries. Studies have identified macro level as well as firm level impact in participating countries. These impacts can vary among economies based on policies of FTAs and some country specific factors.

A. Macro Level Impacts

- **Trade Creation & Trade Diversion effects:** Jacob Viner (1950) introduced the concepts of Trade Creation and Trade Diversion effects in his 'Customs Union Theory'. Trade creation means improvement in consumer welfare as a result of customs union formation. It happens when the member countries replace high-cost domestic production with low-cost import. Domestic production can be expensive due to various reasons such as scarcity of factors, high input cost, high labour cost etc. In such situations countries can form customs union with another country which produce that particular commodity at low cost. This will increase the import from low-cost country. This is known as trade creation. Trade diversion occurs when a country imports high-cost goods from partner country and reducing the low-cost global imports. This will reduce consumer welfare. The level of trade creation and trade diversion will determine the net welfare effect.

  Since the introduction of 'Customs union theory', various theoretical and empirical studies have been conducted. Increase in the number of free trade agreements necessitated this. One country can increase the welfare by forming a trade-diverting customs union (Lipsey, 1957). According to Lipsey, simple conclusion that trade creation is 'good' and trade diversion is 'bad' are no longer valid. Trade diverting customs unions can be welfare improving because of the tendency of consumer to move towards higher indifference curve. But he also confirms that world as whole will suffer when trade diversion is predominant. The empirical studies confirms that FTA formation leads to trade creation and trade diversion effects. These analysis have been conducted with various FTAs of developed, developing and under developed countries. (Deme & Ndrianasy, 2017) showed that free trade agreements between small or low-level income countries are welfare improving for member countries and some non-member countries using ECOWAS as sample. In spite of adverse economic conditions and diverse structural impediments RTAs of developing countries are showing net trade creation effects on all members (Coulibaly, 2004). (Samavong. C, 2018) analysed trade creation and trade diversion effects of ASEAN free trade agreement. The results are in line with the welfare improving effects of trade creation and trade diversion. Trade creating and diverting FTAs are identified with the case of Sri Lanka (Taguchi.H, 2018). Studies on India – ASEAN FTA, ASEAN plus six FTA, ASEAN FTA, SAFTA also recognized the appearance of trade creation and trade diversion (Singh, 2021), (Bhattacharyya & Mandal, 2016), (Islam *et al.*, 2014), (Moktan, 2008).

Sector-specific analysis became a part of trade creation and trade diversion effects in the recent past. The study of (Jagdambe & Kannan, 2020) proved that agricultural sector can be improved through various trade liberalisation mechanisms of FTAs. An import growth driven by trade creation rather than trade diversion is observed in plantation commodities as a result of ASEAN- India Preferential trade agreement (Veeramani & Saini, 2011). A study on the sector-specific analysis of India-Sri Lanka FTA shows trade creation effects than trade diversion effect in selected industrial sectors such as textiles, base metal and machinery equipment. Product diversification and quality up-gradation is also observed from the analysis (Choudhari S *et.al.*, 2013). (Datta & Kouliavtsev, 2009) also found the trade creation effect of textile and apparel trade taking NAFTA as a sample. The presence of trade diversion is also observed in imports of Indonesia's manufactures. (Saleh & Suprayitno, 2010). Study on ASEAN Plus Six FTA also proved the existence of trade creation and trade diversion at sectoral level (Handoyo *et al.*, 2021).

- **Balance of trade impacts:** Balance of trade is the difference in the value of imports and exports of goods of a country over a period. It is a largest component of Balance of payment of a country. The status of balance of trade is an important determinant of foreign exchange reserves and GDP of an economy. An increase of country's export over import is trade surplus of that country. Higher import over export is termed as trade deficit. The existence of trade deficit will lead to decrease in GDP and fall of local currency value. These consequences are harmful especially for developing and underdeveloped economies. Increase in trade deficit has been identified after the formation India-ASEAN Free trade agreement (Singh, 2021). Deterioration of balance of trade of India is noticed in the case of India – ASEAN FTA in the study of (Bhattacharyya & Mandal, 2016) also. FTA formation during the time of global slow down and greater extent of tariff reduction than ASEAN considered to be the reasons for this. Worsening of India's trade deficit with China is estimated in an ex ante analysis India-China FTA (Kalirajan, 2022). 'Behind the border' constraints and other inefficient institutional framework are identified as the reasons for this. (Hussain & Ali Shah, 2022) have a different view on trade deficit. According to them, firms can improve their productivity by importing new technologies. Thus, trade deficit can be a result of these kinds of imports which will benefits the economy in the long run.

- **Market integration**: Market integration between countries means the convergence of prices of goods over a period of time. Market integration can enhance economic growth through competition and specialization. Free trade agreements can contribute to market integration through removal or reduction in tariff barriers. FTAs can intensify competition and specialization through reducing trade cost such as transportation, insurance, paper work etc. Some studies on free trade agreements focuses on this aspect. Many are focusing on law of one price or its aggregated version of Purchasing Power Parity. (Lim & Breuer, 2019) focused on market integration impact of FTAs from trade costs angle. According to them reduction in tariff and trade cost would lead to home-to-foreign price convergence. Taking South Korea as sample, their study shows better market integration after the formation of FTAs.
- **Impact on MFN tariff rate:** Most-Favoured-Nation (MFN) tariff is applicable to the members of WTO. It means treating other people equally. According to WTO agreements, countries can not normally discriminate between their trading partners. Member countries are not supposed to grant someone a special favour and have to do the same for all other WTO members (WTO). FTAs are exception from this under Article 24 of GATT. The proliferation of FTAs became a great concern for countries who are excluded from trading blocs. They have to compete in the international markets with less favourable terms. According to

(Kuenzel & Sharma, 2021) increase in the share of imports from Preferential Trade Partners results decline in MFN tariff rates. Association of increased PTA share with large MFN tariff reductions for products with a greater potential for MFN tariff revenue loss due to trade diversion was observed. Deeper trade agreements contribute more towards this as it can magnify trade diversion effects through more coverage. Thus, trade diversion is the underlying mechanism behind this.

- **GDP Growth:** GDP measures the monetary value of final goods and services—that is, those that are bought by the final user—produced in a country in a given period of time (International Monetary Fund). Increase in real GDP growth can be considered as the indicator of economic growth. Changes in the trends of GDP help policymakers to form better economic policies. According to (Hossain, 2018), removal of SAFTA and AFTA would cause significant losses in the real GDP in member countries. This supports the view that GDP growth can be enhanced by the formation of FTAs.
- **Within country Inequality:** Within country inequality means the internal inequality among the individuals of a country. It can lead to economic instability and financial crisis in any economy. Countries always adopts measures to curtail inequality that exists within the country. Regional integration between countries is capable of reducing within country inequality in member countries (DiCaprio et al., 2017).

B. Firm Level Impacts

- **Local input share:** Local input share is important in free trade agreements because of the existence of Rules of Origin (ROO) criteria. Rules of Origin are an agreed set of rules between countries that share a preferential trade agreement, such as free trade agreements. They determine the criteria for which goods are eligible for free or preferential import tariff (Australian trade & Investment Commission, Australia Government). It means a prescribed amount of local content in importing goods. This criterion can determine the eligibility of a good which has non-FTA input content. Thus, increase in local input share will help countries to meet rules of origin condition in FTAs. The question arise at this context is that, does the participation of multiple FTAs will increase local input share? This question has been answered by (Hayakawa, 2013). The findings of the study show a non-linear relationship between the use of large number of FTAs and higher share of local inputs. But this can be offset by 'Spaghetti bowl phenomenon' which was introduced by Bhagawati *et.al.* This means the trade distortion due to signing of multiple FTAs.

- **Firm level financial factors:** Even though FTAs are part of macroeconomic policies, it is the firms who ultimately adopts these policy of tariff changes. Reduction in tariff rates between countries would make some kind of influence on the financial factors of firms. (Hussain & Ali Shah, 2022) focused on the trends in profits, leverage and dividend payout of the firms in Pakistan and Malysia free trade agreements. It was observed that companies which are facing import competition led to decrease in profit and dividend payouts and enhancement of leverage. Improvement in the efficiency through the adoption of latest technology can bring opposite results for these firms. On the other hand, due to reduction in export tariff rates export oriented companies are able to increase their profit and dividend payouts along with decrease in leverage.

CONCLUSION

The focus of the study was to identify the impacts of the formation of free trade agreements between economies of the world. Various empirical studies on different have been conducted across the globe to identify these factors over time. This includes bilateral trade agreements such as India-Sri Lanka FTA, ASEAN- India FTA, India-China FTA etc. and multilateral trade agreements such as SAFTA, ASEAN FTA, NAFTA etc. Trade creation and trade diversion are the major impacts in member countries irrespective of the nature and location of FTAs. These studies are in line with Jacob Viner's 'Customs Union theory'. Gravity model has been a major estimation strategy for majority of the studies. Time invariant factors such as distance, common colony, common language, common border etc influences the trend in trade volume of economies along with the presence of FTAs. Population, country size (GDP is taken as proxy), depth of FTA etc are the time varying factors which affect trade creation and trade diversion. The effect on balance of trade is also an aspect of empirical studies now a days. Deterioration of balance of trade through increasing trade deficit is observed under different FTAs. A positive aspect of this impact is the possibility of increase in imports of latest technology by the firms which are going to benefit economies in the long run. Market integration through the home-to-foreign price convergence is identifies as a result of FTA formation. GDP growth and reduction in within country inequality are the other results which brings attraction to the creation of trade liberalisation policies. Reduction in the MFN tariff is observed in non-member countries because of the ever increase trend of FTAs. This is the result of trade diverting FTAs across the globe.

In an attempt to pick out the firm level consequences of FTAs, studies have observed increase in the local input share of firms to meet rules of origin as a result of multiple FTAs. Firm level financial factors such as profit, leverage and dividend payouts also get affected by FTA formation. Increase in profit and dividend payout and decrease in leverage have been observed in export-oriented companies. Opposite results have been identified for import competing companies.

It is clear from the above discussion that generalisation of the impacts of FTA formation is difficult. Many factors contribute to the impacts such as nature of FTA, development position of the economy etc. Even though countries are interested in FTAs, they control their trade through some protectionist policies such as non-tariff measures. This will counteract the benefits of FTAs. Thus, countries should keep revising their FTAs over time and clear-cut assessments on the potential benefits of new FTAs should be carried out.

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