Chapter 14
Globalization, Consumer's Preference, and Welfare in India:
Results from CGE Model

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ABSTRACT

The purpose of the present chapter is to analyse general equilibrium effects of different trade liberalization policies for India under imperfectly competitive market structure. Since present day world trade is much akin towards the increasing returns to scale and market structure oriented industry behaviour, we have considered monopolistically competitive market structure for our analysis. Computable General Equilibrium (CGE) modelling has been applied as it seems to be relevant methodology for policy simulation. Consumer's love for variety and increasing returns to scale present in the sectors involving large fixed costs, are strong determinants of consumer's as well as producer's business confidence. Our study reveals that increased welfare gain due to trade and openness is not much larger as compared to standard perfect competition scenario as the scale economy benefit is predominant only in few sectors like capital goods industries and not prominently visible in large agricultural and informal manufacturing sectors.

INTRODUCTION

The present chapter has been devoted to study the consequences of India's foreign trade policy and expanding globalization under market imperfection and diverse consumer preferences. In the present day globalized scenario emergence of scale economy, diverse consumer preference and market structure oriented industry behaviour give rise to the rethinking of international trade especially in the direction of intra industry trade. Firms with bigger capital stock usually reap scale economy benefit from producing greater volume of output and selling them in more than one country. Product differentiation, diverse consumer preference and returns to scale benefit reaped by the firms, eventually affect welfare of the consumers through offering them wide range of varieties and opportunities in reduced and competitive prices. On the other side, market structure oriented industry behaviour and competition among firms to retain market share, significantly affect business

DOI: 10.4018/978-1-4666-9814-7.ch014

confidence of the big multinational firms operating in the open economy globalized scenarios. As those firms generally reap sufficient scale economy benefits and invest in R&D for inventing new varieties, it is very much relevant to study the implication of expanding globalization on firm's business confidence and welfare of the consumers.

The purpose of the present chapter in this context is to comprehend general equilibrium implications of trade liberalization on India's macroeconomic aspects under alternative market structures, giving emphasis on consumer's preference for product variety and presence of increasing returns to scale. We applied Computable General Equilibrium (CGE) modelling as our relevant methodology following Shoven, J.B. and Whalley, J (1984).

CGE based simulation models are commonly used for economic analysis while choosing right policy option among different alternatives. For example, to reduce budget deficit three different policy options are available to the policy maker: a) To increase direct tax b) To increase indirect tax c) Borrowing from the central bank and raise money supply. Now each policy option has its own pros and cons pertaining to macroeconomic effects. Simulation of each policy option provides the knowledge of macroeconomic and welfare effects associated with the execution of such policies. It helps the policy makers as they can choose the right policy option whose effects suits with their goals and objectives.

Constructing a four sector Social Accounting Matrix (SAM) for India paper attempts to purport the effects of liberalized trade over different macroeconomic aspects under monopolistic competition and compared the results with the same obtained under benchmark perfect competition scenario. Three basic research questions will be emphasised through our simulation experiment, a) what are the macroeconomic and welfare effects of trade liberalization under diverse consumer preference? b) Effects of technological progress on social welfare and macroeconomic indicators under imperfect competition and c) Impacts of foreign capital inflow on welfare and macroeconomic indicators under monopolistically competitive market structure.

Our study reveals that trade under imperfect competition could not produce any greater domestic output, expansion of trade in terms of volume of export & import and gains from trade as compared to standard perfect competition scenario.

BACKGROUND

This chapter delineates empirical implementation of a real trade general equilibrium model using computable general equilibrium methodology for a small open economy that includes some features related to "industrial organization" approach to trade. Theoretical study in this area has been developed rapidly by the works of Helpman (1981, 1982), Krugman (1979, 1980, 1981) and many others dealing with imperfect competition, economies of scale, entry barriers, product differentiation and few other aspects of industry structure while judging costs and benefits of trade liberalization. Very early works of Balassa (1966), Corden (1972, 1974), Eastman and Stykolt (1966), and Wonnacott (1967) studied the role of scale economies and its impact on international trade and structure of the industry. Balassa (1966) and Grubel and Loyed (1975) reported that much trade takes place on intra-industry basis which provides solid foundation for inter industry and intra-industry adjustment along with Heckshser-Ohlin argument of comparative cost advantage.

Argument from Industrial Organisation (IO) standpoint predicts that imposition of trade barriers restrict market size and foreign competition promoting too many home firms to operate in an industry exploiting too low scale of production (Krugman 1994, ch. 14). Conventional analysis under perfect competition and constant return to scale predicts the cost of protection to be very small in the order of 0.5 to 2% of the GDP. This