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that potential rationalization gains are realized. Two strategies for import-competing manufacturing firms are considered. The first, analyzed by Professors Eastman and Stykolt in 1967,<sup>(24)</sup> can be described as tariff-limit pricing: domestic prices are set as the price of imports plus the tariff. Given this pricing strategy, lower trade barriers lead firms to reduce their prices and to try to maintain profitability by rationalizing their operations. This response maximizes the rationalization gains. It also helps import-competing firms maintain domestic market share and stimulates exports.

The second strategy involves setting prices as a mark-up on variable costs, with the mark-ups determined by considering the sensitivity of demand to price changes in domestic and foreign markets. Given this pricing strategy, there is no direct link from lower import prices to lower domestic prices and cost reductions through rationalization of production. Lower trade barriers cause the relative price of imports to decline, and domestic firms lose market share.

In the simulations reported in this document, it is assumed that all import-competing firms, which account for about 60 per cent of production in manufacturing, adopt tariff-limit pricing. The gains from free trade are reduced if tariff-limit pricing is considered less prevalent, since there is assumed to be a direct link between lower selling prices, losses and attempts to reduce costs by rationalizing operations.

*The price sensitivity of exports and imports influences the overall gain as well as*

the sectoral effects. The more sensitive are exports and imports to changes in relative prices, the greater will be the shift in resources across industries. The relevance of trade price sensitivities for the overall real income gain arises from their effect on the terms of trade. Increases in the supply of Canadian exports can be absorbed with less downward pressure on export prices the more sensitive demand is to prices. Consequently, if exports are highly price-sensitive, a terms of trade loss is less likely and the real income gain will be augmented.

The parameters determining the sensitivity of imports to relative prices used in the Finance model were developed from an econometric analysis of imports of 70 commodities over the 1961-1981 period.<sup>(25)</sup> This analysis involved development of a new data base on import prices, making use of work undertaken by the Department of Regional Industrial Expansion and the Input-Output Division at Statistics Canada. The export price sensitivity parameters are based on U.S. import demand equations, adjusted to reflect the fact that Canada supplies a small proportion of total U.S. demand for goods. The U.S. import demand equations were taken from the LIFT model, developed at the University of Maryland<sup>(26)</sup>. Trade price elasticities used in the Finance model average 4.1 for exports and 2.7 for imports.

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<sup>(24)</sup> H.C. Estman, and S. Stykolt, *The Tariff and Competition in Canada*, Toronto: Macmillan, 1967.

<sup>(25)</sup> For more details, see the forthcoming Department of Finance Working Paper: *Econometric Estimates of Trade Price Elasticities*.

<sup>(26)</sup> A. Clopper, Jr., M.B. Buckler, L.M. Horwitz, and T.C. Reimbold, 1985: *Interindustry Forecasts of the American Economy*, Lexington Books, Toronto: 1985.