Executive Summary

In recent years, some policy analysts have advocated protectionist trade measures under the rubric of "strategic trade policy". All sorts of trade distorting potions for domestic economic difficulties have been peddled under the strategic trade policy nostrum. This approach is topical and controversial. In parts of the policy community, there is a belief that this prescription should be actively pursued. Yet, free trade is still the best trade policy. Mainstream trade theory and practical experience reassure us that multilateral and regional trade liberalization represents the soundest course.

The objective of this Paper is to: (a) outline the concept and economic logic of strategic trade and industrial policies, (b) present the essence of the debate on implementing these policies in view of the evidence from various countries, and (c) draw conclusions from the strategic trade debate for policy in Canada.

The theory of strategic trade suggests that if the government commits itself to subsidize "our" companies, foreign competitors can be driven out of concentrated international markets. Assuming that other governments do not retaliate, "we" can <u>shift rents</u> from "them" to "us". In the presence of economies of scale, incremental costs fall as producers move down their learning curve. Our government can ensure the long run viability of our companies by subsidizing the sunk costs of setting up large operations with spare capacity. Should the foreigners contest the market, our corporations would undercut their prices by cranking up volume and achieving lower unit costs. Strategic trade policy would enable our companies to capture rents in imperfectly competitive markets at the expense of our rivals. So goes the theory.

Industrial policy purports to work by moving resources from sectors that the government considers less desirable to those that it thinks are worth having in the country. In theory, government intervention in the guise of industrial policy can be justified on account of market failure. However, the proponents of industrial policy have jumped to policies which can generate popular appeal, but enjoy limited economic merit. We examine a few such arguments in this Paper. How and why should governments pick companies in growth oriented high technology industries and give them money to set up shop? Because these companies will generate rents and provide well paying jobs, the argument goes, government should subsidize selected corporations or industries that produce high value added goods.

The problem with these arguments is that if these businesses are valuable, now and in the future, the marketplace will allocate and shift resources without government programmes in most industries. It is possible that markets are not doing a perfect job. But to implement strategic trade and industrial policies, the authorities require detailed information on market concentration, the magnitude of spillover effects, and the reaction of our trading partners before