

ANNEX

1. Imperfect Competition and Strategic Trade Policy

The observation that in some international markets there are only a few firms in effective competition led to the theoretical thinking about strategic trade in the late 1970s with Kattrak⁴⁸, Svedberg⁴⁹, and Brander and Spencer⁵⁰. In concentrated markets, firms set prices in excess of the marginal cost of production, which results in firms typically making excess returns. There will be an international competition over who gets these profits. In theory, it is possible for a government to alter the rules of the game to shift these excess returns from foreign to domestic firms. In the simplest case, a subsidy to domestic firms, by deterring investment and production by foreign competitors, can raise the profits of domestic firms by more than the amount of the subsidy. Setting aside the effects on consumers—for example, when the firms are selling only in foreign markets—this capture of profits from foreign competitors would mean that the subsidy raises national income at other countries' expense. Originally proposed by the economists Barbara Spencer and James Brander, this argument locates the market failure that justifies government intervention in the lack of perfect competition.

● The Brander-Spencer Argument: An Example

Consider a situation in which only two firms compete, say Boeing from the U.S. and Airbus from Europe. Both firms are capable of making a new product, say a 150-seat aircraft. We require that each firm makes only a yes/no decision: either to produce 150-seat aircraft or not.

⁴⁸ Homi Kattrak, "Multinational Monopolies and Commercial Policy", *Oxford Economic Papers*, (29) 1977: 283-91.

⁴⁹ Peter Svedberg, "Optimal Tariff Policy on Imports from Multinationals", *Economic Record*, (55) 1979: 64-7.

⁵⁰ James A. Brander and Barbara J. Spencer, "Tariffs and the Extraction of Foreign Monopoly Rents Under Potential Entry", *Canadian Journal of Economics*, (14) 1981: 371-89.