doing the best it can, in the sense of maximizing profit through the choice of its own output level, given the output level of its rival. With only two firms, each firm can generally earn relatively large profits. Furthermore, each firm could earn even greater profit if it could persuade its rival to cut back output.

Suppose that the Japanese firm discovers how to produce output more efficiently and is able to lower its costs of producing additional output. In the new Cournot equilibrium, the innovative Japanese firm will have a higher share of the world market and the U.S. firm will have a smaller share. The Japanese firm benefits twice from lower cost. First, it gains profits directly because costs fall. Second, the lowered costs improves its strategic position in the world market and indirectly induces the rival to contract. This contraction by the U.S. firm makes it possible for the Japanese firm to increase its profit. Thus, the Japanese firm benefits by more than the amount of the cost saving.

- **Profit-Shifting Trade Policy in Imperfectly Competitive Markets**

Consider an export subsidy (or a production subsidy) in Japan. The subsidy has the same effect as an innovation that lowers costs. A subsidy makes it economical for the Japanese firm to expand its output, even taking the output of the U.S. firm as given. The Japanese firm's expansion of output is credible. The rival U.S. firm can best respond by contracting output. In effect, the subsidy makes it possible for the Japanese firm to stake out a larger market share of a profitable international market than it otherwise could.[7]

Is the export subsidy policy in the national interest?[8] There are two effects of the subsidy: the transfer effect and "strategic" effect. First, the cost of the subsidy is the additional tax burden on rate payers, but this tax is offset by lower costs to consumers and thus amounts to a transfer. Second, profits of the Japanese firm rise by *more* than the amount of the subsidy. The benefit to the firm exceeds the cost to taxpayers. Provided shareholders of the firm are Japanese nationals, *this subsidy policy is in the national interest*. But this policy is predatory. The gain to the Japanese economy comes completely at the expense of the U.S. firm.[9]

The main element in the strategic trade policy argument is that governments have access to tools such as subsidies, which the firms cannot generate internally, that can further deter rivals. Such government policies can lead to a national advantage. However, this case for

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[7] A numerical example of how a government's strategic trade policy can shift rents in international markets from foreign to domestic firms is provided in the Annex.

[8] National interest is the maximization of the total real value of goods and services at the command of the whole society.

[9] For the detailed model, see James A. Brander and Barbara J. Spencer, "Export Subsidies and International Market Share Rivalry", *Journal of International Economics*, (18) 1985: 83-100.