competitors still want to contest the market with us, our firms can expand output and lower unit costs to undercut the rivals' price. "They" are driven out and "we" capture the market. So goes the theory.

1.2 Strategic Trade Policy and Industrial Policy

In addition to rent-capturing through export promotion, advocates of strategic trade policy suggest other benefits of targeting and promoting high technology industries. One feature of many industries employing skilled workers and advanced technology is that the R&D in one sector has beneficial spillovers in the rest of the economy. On account of this theoretical reasoning, it makes sense for a government to target such industries and provide them subsidies to exploit their favourable effects. This is the old argument of industrial policy. From the viewpoint of industrial targeting, the proponents of strategic trade policy have basically extended the industrial policy argument to international trade. Industrial policy is an attempt by a government to encourage resources to move into particular sectors that the government views as important to future economic growth. Industrial policy has been practised with mixed results by countries such as Japan, France and, to some extent, by the United States and Canada. Several practical case studies are summarized in section 3.

The rest of this Paper is set out as follows. Section 2 sets out the theory and some considerations related to strategic trade policy and industrial policy. In section 3, we assess the relevance of these policies. In section 4, we do an assessment of strategic trade policy from Canada's trade perspective. Conclusions are found in section 5. In the Annex, imperfect competition and strategic trade policy are further illustrated. A companion study released as Staff Paper no. 93/16 explores more fully the impact of industrial and strategic trade policies on Japan's economic performance.

2 STRATEGIC TRADE THEORY AND INDUSTRIAL POLICY

2.1 The Stylized Theory of Strategic Trade Policy

Let us present, in a very stylized environment, the case of welfare improving policy that involves the use of subsidies to enhance the strategic position of a domestic firm engaged in competition for world markets with a foreign rival. Imagine that there are two firms, one Japanese and one U.S., serving a world market contained entirely in other countries. Each firm recognizes that its profit depends in part on what its rival does. How will firms behave in such a situation of a "strategic game"? In many possible ways. The Cournot or Bertrand models are two plausible theories.[6] Cournot's idea is that stable equilibrium will occur when each firm is

[6] In the Bertrand model, oligopolistic firms compete by setting the price of their product. A good exposition of the Bertrand and Cournot models is in Jean Tirole, *The Theory of Industrial Organization*, M.A.: MIT Press, 1988, chapter 5.