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## Note on Theories of Strategic Trade: Beyond Comparative Advantage

### Introduction

*The theory of comparative advantage* suggests that free trade generally raises a country's national income, while government actions to limit trade generally lower incomes. This perspective, which is almost universally accepted among professional economists, has substantial historical support and can explain a vast majority of international trade phenomena. In the past few decades, however, economists have explored a variety of special situations where intervention has the potential to improve national income.

The so-called *New International Economics* (alternatively, *Strategic Trade Theory*) explores situations where markets economic conditions depart from standard conditions—because of market power, economies of scale, externalities, etc. Economists have shown that it is theoretically possible for government intervention to improve national incomes. Whether such interventions work in practice is a different question.

This note unpacks several *Strategic Trade* models, and seeks to explain the logic behind each. It concludes with several critiques of the models. The note assumes the reader is familiar with the material in “Trade and Comparative Advantage” (GloLens #1-428-934).

### Strategic Trade Theories

Most Strategic Trade models revolve around one of four special situations that depart from the classical economic setting of perfect competition. These are:

- *Market power in trade* – that is, one participant has the power to set prices or restrict output;
- *Economies of scale in production* – marginal and average costs decline as volume within one period increases;
- *Learning by doing* – marginal and average costs decline as cumulative production increases; and
- *External economics* – production of one good affects the cost of another good, through technology spillovers, pollution, etc.

The first three relate to policies designed to secure rents, or supranormal profits for a country. The fourth relates to the theory of externalities.



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