

# **"Knowledge Spillovers, Market Power and Innovation under Trade Shocks"**

## **Abstract**

This paper studies how trade shocks shape firm innovation through the interaction of sectoral knowledge spillovers and market power. I combine firm-level evidence from two major events—China’s WTO accession and the 2018 U.S. trade war—with a simple two-country model. Empirically, I show that tariff liberalization increased innovation less in high-spillover Chinese sectors, while protectionist shocks in the U.S. amplified innovation responses in such sectors; in both cases, firms with greater market share adjusted innovation more strongly. The model features innovative firms that invest in R&D alongside non-innovators who benefit from diffusion. Spillovers reduce innovation costs but also intensify diffusion-driven competition, generating heterogeneous responses to trade shocks. Calibrated to the data, the model implies that targeted, sector-specific transfers can offset heterogeneous losses and sustain innovation, whereas uniform policies are less effective.