

Notes on trade and industrialization policy, in Turkey and elsewhere

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Abstract

Standard trade theory predicts that trade liberalization will result in inefficient, protected industries being swept away by the forces of global competition, with new industries more in line with the country's comparative advantage taking their place. In Turkey, as well as in most countries opening up to trade during the 1980s and 1990s, some of the most heavily protected industries have been those that led the way in terms of exports. This pattern of export performance suggests a fundamental lesson about economic development. Economic development is best achieved under a mixed policy regime that combines market discipline with government promotion.

1. Introduction

There has been probably no more perceptive an observer of the Turkish economy than Merih Celasun. In all areas that he wrote on -including income distribution, macroeconomic adjustment, and trade policy- Merih Celasun left his distinctive imprint. He took his time to make up his mind, and facile conclusions were not his style. Instead, he grounded his conclusions in rigorous empirical analysis and on

¹ This paper was prepared as a contribution to this special issue of *METU Studies in Development* commemorating the life and work of Professor Merih Celasun. I thank Prof. Fikret Şenses and the editors for asking me to be part of it. This paper draws heavily on my "Industrial Policy for the Twenty-First Century," September 2004.

insights developed over a long period of observing the Turkish economy.

I want to take as my starting point for this paper an observation that Merih Celasun made in connection with Turkey's industrialization pattern during its post-1980 outward-oriented phase. He wrote:

“Turkey's post-1980 export performance has been largely structured around existing capacities built in the pre-1980 inward-oriented growth era, which emphasized the import substitution (IS) motive in trade regimes and investment programming. The Turkish case demonstrates the overall feasibility of switching from IS strategy to outward-orientation in the latter stages of the industrialization process” (Celasun, 1994: 454).

What this quote points to is an interesting puzzle, and one that is not specific to Turkey. The typical pattern in countries opening up to trade during the 1980s and 1990s is that some of the old IS industries have been among those that responded the most vigorously. Standard trade theory -and most economists advocating openness- would have predicted otherwise. Trade liberalization was supposed to lead to a fundamentally different pattern of specialization. The old, inefficient IS industries propped up by trade protection would be swept away by the forces of global competition, while new industries more in line with the country's comparative advantage would take their place. Instead, the resulting export drive was often led by those same old IS industries. And when successful new export industries did arise, they were themselves hardly the result of unadulterated market forces and of comparative advantage: they turned out to be the result of preferential policies not too dissimilar from those that had prevailed under the IS regime.

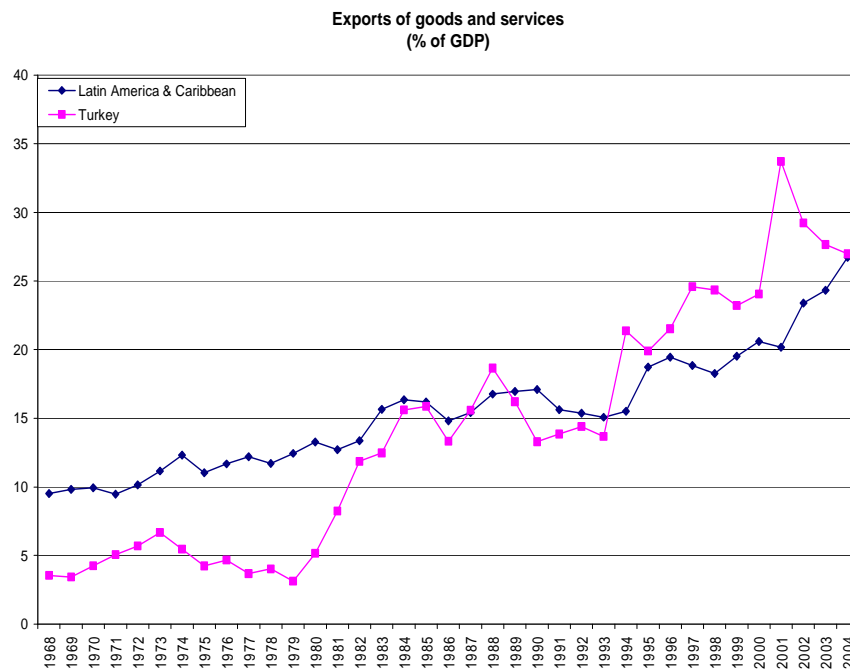
I explore in this paper this paradox. I will argue that the pattern of export performance we have seen suggests a fundamental lesson about economic development. Economic diversification and development is best achieved under a mixed policy regime that combines market discipline with government promotion. Too much government promotion and we end up locking too much of the economy's resources in inefficient production structures. That was the downside of the IS regimes of the past. Too much market discipline and we have inadequate rents for entrepreneurs to invest in risky new economic activities. That has been the curse of the liberal economic policy regime adopted most notably in Latin America since the late 1980s. Intelligent policy design for growth and development

must navigate between these two unprofitable extremes. I will provide some pointers about how to achieve this towards the end of the paper.

2. Some evidence

The most striking consequence of the shift towards outward orientation has been a rapid rise in exports. Figure 1 compares Turkey's export performance with that of Latin America, a region that opened up to trade in the mid- to late-1990s. The sharp increase in Turkey's exports in the early 1980s compares quite favorably to that experienced by Latin America subsequently. In Latin America, exports rose by about 13 percentage points of GDP following liberalization, whereas in Turkey the increase was more than 20 percentage points.

Figure 1
Export Performance



Source: World Development Indicators, World Bank

Where did the increase in exports come from? Table 1 shows the top five export items of three Latin American countries (Brazil, Mexico, and Chile) to the U.S. market. Leaving aside traditional

exports such as copper for Chile or shoes for Brazil, practically all of the export successes in these countries have been shaped in some part by public policies. Aircraft and steel in Brazil were the subject of explicit industrial policies, through trade restrictions and subsidies, and are archetypal IS industries. In Chile, grapes and fish were boosted early on by publicly funded R&D and dissemination activities, and forestry products have a long history of subsidized plantations. In Mexico, motor vehicles and electronics are the creation not of free trade policies, but of early IS policies combined later with preferential tariffs granted by the U.S. under the maquila program and NAFTA. Beneath the surface of non-traditional export success stories, we find more often than not industrial policies, public R&D, sectoral supports, export subsidies, or preferential tariff arrangements.

The same is largely true of Turkey as well. I have listed the top 10 export items of Turkey in Table 2. Many of the products in the list are labor-intensive commodities that one would have expected Turkey to specialize in: T-shirts, women's and men's suits, pullovers, linens, and the like. But the others are more surprising from the perspective of standard notions of comparative advantage. Turkey has now become a major exporter of motor vehicles, auto parts, steel, TVs, and military aircraft. Steel, consumer electronics, and motor vehicles are classic IS industries. It would not have been unreasonable to expect these industries to have been wiped by the competitive forces ushered by trade liberalization, especially in the aftermath of the customs union agreement with the European Union. Instead, these industries have emerged stronger and are leading the way for the productive development of the Turkish economy.

Another perspective on the same phenomenon is provided by taking a look at the evolving structure of Turkish industry and analyzing its relationship with the structure of trade protection. Some of the fastest growing industries since 1980, and especially the 1990s, have been IS industries which were nurtured behind high levels of trade protection.² Figure 2 provides a scatter plot of the contribution of each 4-digit ISIC industry to overall industry growth between 1981 and 1997 against the average tariff protection received by that industry in 1993. (I exclude tobacco processing, which is an outlier with its very high rate of protection.) Each industry is identified in the scatter plot with its 4-digit code. As the figure shows, some of the largest

² Şenses and Taymaz (2003) also emphasize the absence of structural change in Turkey following the reforms of the 1980s.

contributions to growth came from industries such as motor vehicles (ISIC 3843) and iron and steel (ISIC 3710), industries that were still receiving a moderate amount of protection in the early 1990s. In fact, to the extent that there is a relationship between the amount of protection received by an industry and its contribution to overall growth, it is an inverse U-shaped one. (A quadratic fit yields statistically significant coefficients on both terms.) Moderate levels of protection -neither too high nor too small- is associated with the best performance.

Table 1
Latin American Export Successes

Top 5 export items (HS4) to the U.S. (in 2000)		
Country	Item	Value (\$ mil)
Brazil	Aircraft	1,435
	Shoes	1,069
	Non-crude petroleum	689
	Steel	485
	Chemical woodpulp	465
Chile	Copper	457
	Grapes	396
	Fish	377
	Lumber	144
	Wood	142
Mexico	Motor vehicles	15,771
	Crude oil	11,977
	Computers & peripherals	6,411
	Ignition wiring sets	5,576
	Trucks	4,853

Source: U.N. COMTRADE.

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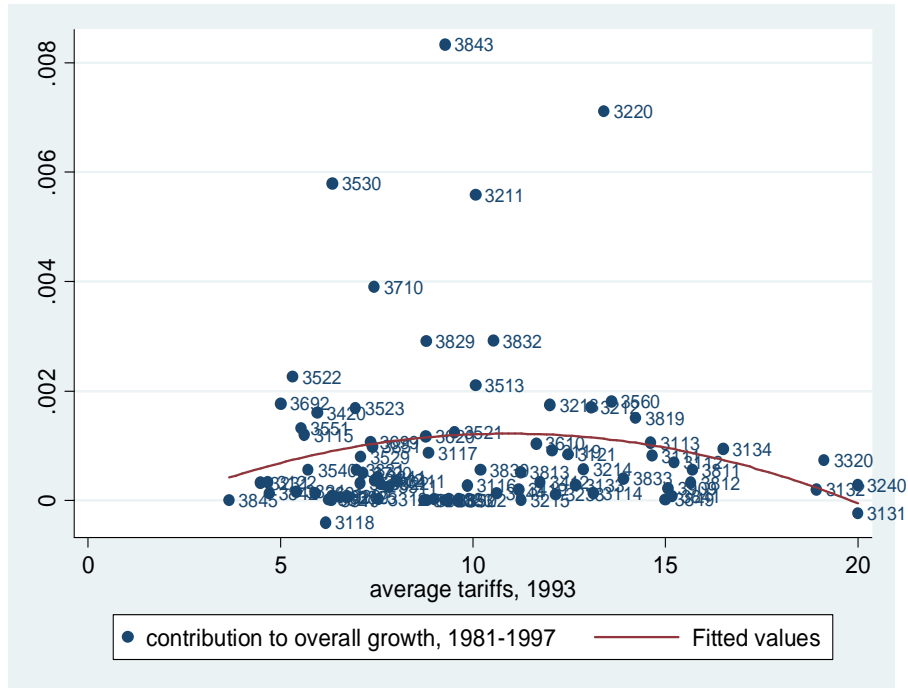
Table 2
Turkish Export Successes

Top 10 export items (HS\$) of Turkey (in 2000)	
Item	Value (\$ mil)
T-shirts	1,258
Women's or girls' suits	1,045
Jerseys, pullovers	887
Television receivers	830
Steel bars, rods	669
Airplane industry	642
Motor vehicles	628
Men's or boys' suits	595
Bed and table linen	543
Motor vehicle parts	450

Source: U.N. COMTRADE.

I conclude this section by citing one of the conclusions from Togan's (1994) study of trade liberalization in Turkey. Togan (1994, 227) found that export industries have typically received higher rates of effective protection (ERP) than import competing industries: in 1991 the corresponding ERPs were 71% for export industries and 40% for import-competing industries. This again serves to highlight the apparent paradox noted by Merih Celasun and discussed here.

Figure 2
Tariff Protection Versus Contribution to Growth, 80 Turkish Industries



Source: Calculated using data from Nicita and Olarreaga (2001).

3. Making sense of the paradox

To make sense of the paradox that a country's most competitive industries often turn out to be the ones that were the beneficiaries of preferential policies in the past, we need to resuscitate an old idea in the theory of economic policy: while markets do a good job of ensuring static efficiency, they often fail to ensure dynamic efficiency. Economic growth is hardly ever the result of static comparative advantage. Building domestic industrial capabilities requires nudging the private sector to make investments that they would not have made on their own.

It is one of the central tenets of the policy consensus of the last couple of decades that developing countries should specialize according to their comparative advantages. Yet the evidence points in a somewhat different direction. Imbs and Wacziarg (2003) recently examined the patterns of sectoral concentration and diversification in

a large cross-section of countries. They found that countries that are getting richer are those in which sectoral production and employment become less concentrated and more diversified. And this process goes on until relatively late in the process of development. It is only after countries reach roughly the income level of Ireland that production patterns start to become more concentrated. This seems to be a robust feature of economic development, both across countries and within countries over time.

The logic of comparative advantage is one of specialization rather than diversification. Therefore, whatever it is that serves as the driving force of economic development, it cannot be the forces of comparative advantage as conventionally understood. The trick seems to be to acquire mastery over an expanding range of activities, instead of concentrating on what one already does best.

The trouble is that diversification is not a natural process and it can be easily derailed. To see this, consider an economy in which macroeconomic instability is not a problem, market interventions are minimal, trade restrictions are few and far in between, property rights are protected, and contracts are enforced. Will the type of entrepreneurship that is required to build up non-traditional activities be amply supplied?

There are good reasons to believe that the answer is no. Most fundamentally, prevailing market prices cannot reveal the profitability of resource allocations that do not yet exist.⁴ The returns from investing in non-traditional activities are therefore hazy at best. In the language of conventional economics, there are two key externalities that blunt the incentives for productive diversification: information externalities and coordination externalities. Both are reasons to believe that diversification is unlikely to take place without directed government action (or coordination among producers).

3.1. Information externalities

Diversification of the productive structure requires “discovery” of an economy’s cost structure - i.e., knowledge about which new activities can be produced at low enough cost to be profitable. Entrepreneurs must experiment with new product lines. They must tinker with technologies from established producers abroad and adapt them to local conditions. This is the process that Ricardo Hausmann

⁴ In general equilibrium theory, this is finessed by assuming that markets are “complete” and there is a price for everything.

and I called self discovery” (Hausmann and Rodrik 2003), and which seems integral to the stylized facts about development uncovered by Imbs and Wacziarg (2003).

When we put ourselves in the shoes of an entrepreneur engaged in cost discovery, we immediately see the key problem: this is an activity that has great social value and yet is very poorly remunerated. If the entrepreneur fails in his venture, he bears the full cost of his failure. If he is successful, he has to share the value of his discovery with other producers who can follow his example and flock into the new activity. In the limit, with free entry, entrepreneurship of this kind produces private costs and social gains. It is no great surprise that low-income countries are not teeming with entrepreneurs engaged in self-discovery.

Note that the kind of discovery that matters in this context differs from innovation and R&D as these terms are commonly understood. What is involved is not coming up with new products or processes, but “discovering” that a certain good, already well established in world markets, can be produced at home at low cost. This may involve some technological tinkering to adapt foreign technology to domestic conditions, but this tinkering rarely amounts to something that is actually patentable and can therefore be monopolized. The entrepreneurs who figured out that Colombia was good terrain for cut flowers, Bangladesh for t-shirts, Pakistan for soccer balls, and India for software generated large social gains for their economies, but could keep very few of these gains to themselves. The policy regimes in developing countries have no analogues to the patent system that protects innovation in the advanced countries.

In Hausmann and Rodrik (2003), we provided some informal evidence to suggest that these features are endemic to the process of economic development. We showed that countries with nearly identical resource and factor endowments specialize in very different types of products, once one looks beyond very broad aggregates such as labor-intensive commodities. Bangladesh exports millions of dollars worth of hats, while Pakistan exports virtually none. Conversely, Pakistan exports tons of soccer balls, while Bangladesh lacks a significant soccer ball industry. At a different level of income, Korea is a world power in microwave ovens and barely exports any bicycles, while the pattern is reversed in Taiwan. It is impossible to ascribe these patterns of specialization to comparative advantage. They are more likely the result of random self-discovery attempts, followed by imitative entry. Indeed, we showed how whole industries

often arise out of the experimental efforts of lone entrepreneurs. Garments in Bangladesh, cut flowers in Colombia, IT in India, and salmon in Chile (with a state entity acting as the entrepreneur in the last case) are some of the better documented cases. In each one of these cases, imitative entry through managerial and labor turnover, was the key mechanism that enabled industry growth (while undercutting the rents of incumbent entrepreneurs).

The first-best policy response to the informational externalities that restrict self-discovery is to subsidize investments in new, non-traditional industries. As a practical matter, it is difficult to implement such a subsidy. The difficulty in monitoring the use to which the subsidy would be put -an investor might as well use it for purposes that provide direct consumption benefits- renders the first-best policy intervention largely of theoretical interest.⁵ In Hausmann and Rodrik (2003), we recommend generically a carrot-and-stick strategy. Since self-discovery requires rents to be provided to entrepreneurs, one side of the policy has to take the form of a carrot. This can be a subsidy of some kind, trade protection, or the provision of venture capital. Note that the logic of the problem requires that the rents be provided only to the initial investor, not to copycats. To ensure that mistakes are not perpetuated and bad projects are phased out, these rents must in turn be subject either to performance requirements (for example, a requirement to export), or to close monitoring of the uses to which they are put. In other words, there has to be a stick to discipline opportunistic action by the recipient of the subsidy. East Asian industrial policies have typically had both elements (see the classic discussion in Amsden (1989) and Wade (1990)). Industrial policies in Latin America and in Turkey (prior to the 1980s) typically have used too much of the carrot, and too little of the stick, which explains why these places have ended up with much inefficiency alongside some highly competitive industries.

A subtle but important point here is that that even under the optimal incentive program, some of the investments that are promoted will turn out to be failures. This is because optimal cost discovery requires equating the social marginal cost of investment funds to the *expected* return of projects in new areas. The realized return on some of the projects will necessarily be low or negative, to be compensated

⁵ The situation is somewhat analogous with respect to technological externalities that flow from R&D. In this case, the first-best is an R&D subsidy. But advanced countries provide patent protection, which is second-best, to stimulate R&D.

by the high return on the successes. The stunning success that Fundacion Chile -a public agency- achieved with salmon can pay for many subsequent mistakes.⁶ It has been estimated that six investments alone have generated enough return to cover all of Fundacion Chile's expenses over its lifetime. In fact, if there are no or few failures, this could even be interpreted as a sign that the program is not aggressive or generous enough.

However, a good industrial policy will prevent such failures from gobbling up the economy's resources indefinitely, and it will ensure that they are phased out. The trick for the government is not to pick winners, but to know when it has a loser.

3.2. Coordination externalities

Many projects require simultaneous, large-scale investments to be made in order to become profitable. Consider for example an investor in the cut flower industry. An individual producer contemplating whether to invest in a greenhouse needs to know that there is an electrical grid he can access nearby, irrigation is available, the logistics and transport networks are in place, quarantine and other public health measures have been taken to protect his plants from his neighbors' pests, and his country has been marketed abroad as a dependable supplier of high-quality orchids. All of these services have high fixed costs, and are unlikely to be provided by private entities unless they have an assurance that there will be enough greenhouses to demand their services in the first place. This is a classic coordination problem. Profitable new industries can fail to develop unless upstream and downstream investments are coaxed simultaneously.

More generally, coordination failures can arise whenever new industries exhibit scale economies and some of the inputs are non-tradable (or require geographic proximity) (Rodrik 1996). Big push models of development are based on the idea that such features are predominant in low-income environments. The cluster approach to development represents a narrower version of the same idea, focusing on the development of specific sectors such as tourism,

⁶ Fundacion Chile is a public agency that was created by funds donated by ITT. It began experimenting with salmon in the second half of the 1970s and set up a firm in the early 1980s using a technology adapted from that in Norway and Scotland. The company was eventually sold to a Japanese fishing company. Before Fundacion Chile's efforts, Chile exported barely any salmon. The country is now one of the world's biggest salmon exporters.

pharmaceuticals, or bio-tech. In all these versions, the coordination failure model places a premium on the ability to coordinate the investment and production decisions of different entrepreneurs. Sometimes, when the industry in question is highly organized and the benefits of the needed investments can be localized, this coordination can be achieved within the private sector, without the government playing a specific role. But more commonly, with a nascent industry and a private sector that has yet to be organized, a government role will be required.

An interesting but often neglected aspect of coordination failures is that they do not necessitate subsidization, and overcoming them need not be costly to the government budget. In this respect, coordination externalities differ from the information externalities discussed above, which do necessitate subsidies of some sort. It is the logic of coordination failures that once the simultaneous investments are made, all of them end up profitable. Therefore none of the investors needs to be subsidized *ex post*, unless there is an additional reason (i.e., a non-pecuniary externality) that such subsidization is required. The trick is to get these investments made in the first place. That can be achieved either by true coordination -“Firm A will make this investment if Firm B makes this other investment”- or by designing *ex ante* subsidies that do not need to be paid *ex post*. An implicit bail-out, or an investment guarantee is an example of such an *ex-ante* subsidy. Suppose the government guarantees that the investor will be made whole if the project fails. This induces the investor to proceed with the investment. If the project succeeds, the investor does not need any cash transfer from the government, and no subsidies are paid out. This is one way in which some industries got started out in South Korea, as the regime of President Park gave implicit investment guarantees to leading Chaebols that invested in new areas. On the other hand, this type of policy is obviously open to moral hazard and abuse; for a while it was common to blame the Asian financial crisis on the “cronyism” engendered by these implicit bail-out guarantees.

The policies that overcome coordination failure share an important characteristic with those focused on information externalities. Both sets of interventions need to be targeted on activities (a new technology, a particular kind of training, a new good or service), rather than on sectors *per se*. It is activities that are new to the economy that need support, not those that are already established.

When viewed from the perspective of the discussion above, it is not surprising to observe that industrial restructuring rarely takes place

without significant government assistance. The difference between East Asia and other parts of the world is not that industrial transformation has been state-driven in one and market-driven in the other. It is that industrial policy has not been as concerted and coherent elsewhere as it has been in East Asia, with the consequence that the transformation has been less deeply rooted in the former than it is in the latter.

4. But what kind of an industrial policy?

In the previous section, I linked the need for industrial policy to two key market failures that weaken the entrepreneurial drive to restructure and diversify low-income economies. One has to do with the informational spillovers involved in discovering the cost structure of an economy, and the other has to do with the coordination of investment activities with scale economies. But there are two key issues that bedevil the conduct of industrial policy.

First, the public sector is not omniscient, and indeed typically has even less information than the private sector about the location and nature of the market failures that block diversification. Governments may not even know what it is they do not know. Consequently, the policy setting has to be one in which public officials are able to elicit information from the business sector on an ongoing basis about the constraints that exist and the opportunities that are available. It cannot be one in which the private sector is kept at arms' length and autonomous bureaucrats issue directives. To use Evans' (1995) terminology, industrial policy-making has to be *embedded* within a network of linkages with private groups.

Second, industrial policy is open to corruption and rent-seeking. Any system of incentives designed to help private investors venture into new activities can end up serving as a mechanism of rent transfer to unscrupulous businessmen and self-interested bureaucrats. The natural response is to insulate policymaking and implementation from private interests, and to shield public officials from close interaction with businessmen. Note how this impulse -“keep bureaucrats and businessmen distant from each other”- is diametrically opposed to the previous one arising from the need for information flows.

The critical institutional challenge therefore is to find an intermediate position between full autonomy and full embeddedness. Too much autonomy for the bureaucrats, and you have a system that minimizes corruption, but fails to provide the incentives that the private sector really needs. Too much embeddedness for the

bureaucrats, and they end up in bed with (and in the pockets of) business interests. Moreover, we would like the process to be democratically accountable and to carry public legitimacy.⁷

Getting this balance right is so important that it overshadows, in my view, all other elements of policy design. In particular, once the institutional setting is “right,” we need to worry considerably less about appropriate policy choice. A first-best policy in the wrong institutional setting will do considerably less good than a second-best policy in an appropriate institutional setting. Put differently, when it comes to industrial policy specifying the process is more important than specifying the outcome.

Thinking of industrial policy as a “process” has the added benefit that it leaves open the possibility that the actual obstacles to diversification may differ significantly from those hypothesized above. Listening to businessmen without getting captured may reveal that the real problems are not the government’s errors of omission (e.g., externalities that have not been internalized), but its errors of commission (e.g., misguided interventions that have increased the cost of doing business). Occasionally, the problems may lie in unexpected areas - for example a quirk in the tax code or a piece of otherwise innocuous legislation. Policy recommendations based on *ex-ante* reasoning would get it badly wrong in such cases.

These ideas have much in common with the recent literature on institutional innovation, which emphasizes the shortcomings of the hierarchical, principal-agent model of governance in environments of volatility and deep uncertainty (see in particular Sabel 2003, 2004). Solving the problems outlined in the previous section involves social learning - discovering where the information and coordination externalities lie and therefore what the objectives of industrial policy ought to be and how it is to be targeted. In this setting, the principal-agent model, with the government as the principal, the firms as its agent, and an optimal policy which aligns the agents’ behavior with the principal’s objectives at least cost, does not work very well. What is needed instead is a more flexible form of strategic collaboration between public and private sectors, designed to elicit information about objectives, distribute responsibilities for solutions, and evaluate outcomes as they appear. An ideal industrial policy process operates in an institutional setting of this form.

⁷ The short survey of Turkey’s industrial policies in Şenses and Taymaz (2003) reveals the large gap between these desiderata and actual practice in Turkey.

As Charles Sabel emphasizes, institutions of learning have to be experimentalist by their nature. Just as discovering underlying costs require entrepreneurial experimentation, discovering the appropriate ways in which restructuring bottlenecks can be overcome needs a trial-and-error approach to policymaking.

5. Concluding remarks

None of the discussion above would have come as a surprise to Merih Celasun. He was among those rare economists who managed to avoid the ideological extremisms of his time: he was not a devotee of statism and central planning when those were in vogue, and rejected blind attachment to market fundamentalism and neoliberalism when these became dominant. The mark of a great economist is his willingness to let the real world shape his views about economic policy instead of abstract theories and models. “Merih Hoca”’s brand of pragmatic, empirically-grounded economic analysis remains a beacon of light for all of us who are trying to make economics as useful as it is relevant.

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Özet

Türkiye’de ve diğer ülkelerde ticaret ve sanayileşme politikası üzerine notlar

Standart ticaret teorisi, serbestleşmeyle birlikte küresel rekabetin etkin olmayan korunmalı endüstrileri ortadan kaldıracağını ve bu endüstrilerin yerini ülkenin mukayeseli üstünlükleri çerçevesinde faaliyet gösteren yeni endüstrilerin alacağını öngörür. 1980 ve 1990’larda ekonomilerini ticarete açan diğer ülkelerin birçoğunda da olduğu gibi, Türkiye’de ihracata öncü olan endüstriler, en yoğun korumaya tabi olanlar idi. İhracat performansındaki bu gözlem iktisadi gelişme için temel bir ders vermektedir. İktisadi gelişme en iyi piyasa disiplini ile hükümet desteğinin karışımı olan politikalar ile sağlanır.