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**Davos versus Porto Alegre:
A survey on key issues behind international trade and
financial integration and liberalisation**

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As the two meetings of Davos and Porto Alegre came to an end some months ago, the issue of trade openness and financial liberalisation is once again put in the front stage. Are the two antagonist views embodied in each meeting irremediably opposite or, as Brazil's President seemed to support it, could they be reconciled in some ways? To answer this question, it is necessary to first go back to what trade openness and financial liberalisation mean and how they are in fact two sides of the same coin. This will allow us to focus on the theoretical arguments of the issue at stake, their conclusions and limits. It will appear that the relationship between trade openness / financial liberalisation and growth is not a simple and automatic one: rather it involves many other considerations, which require a country by country analysis and solution.

1- Trade Openness and Financial Liberalisation

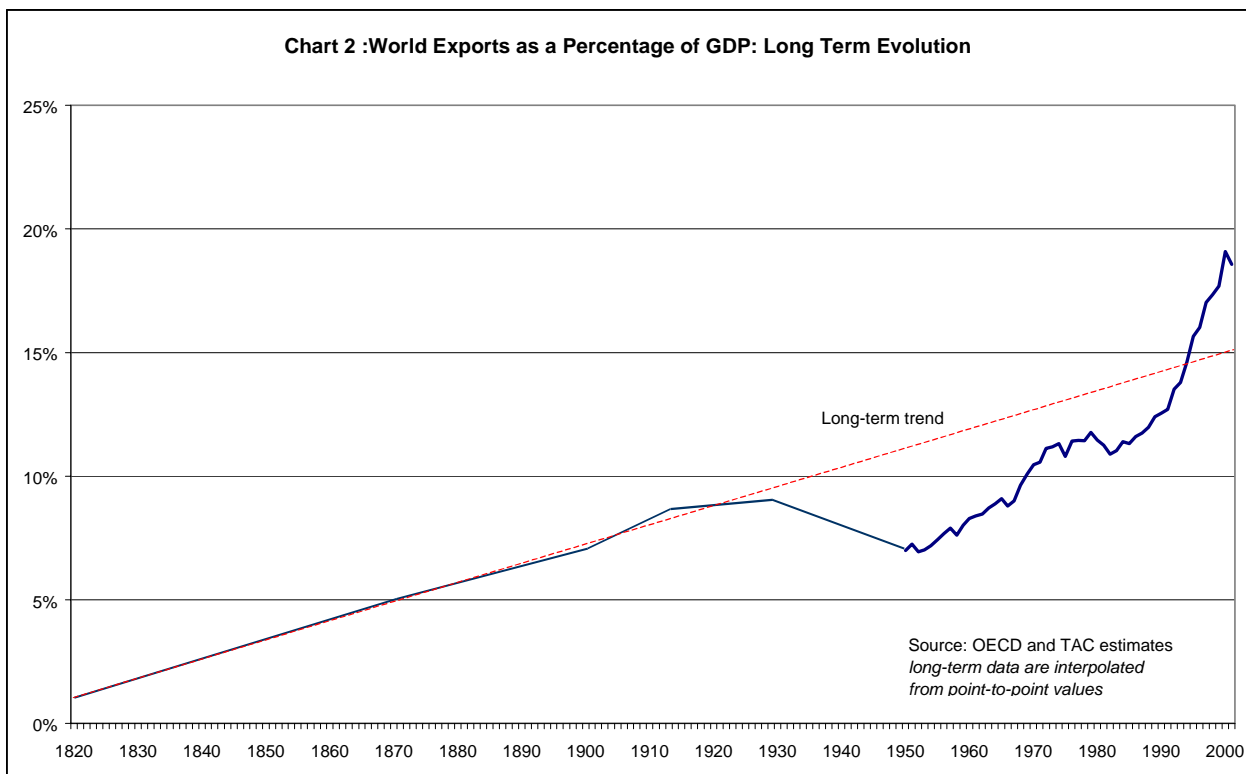
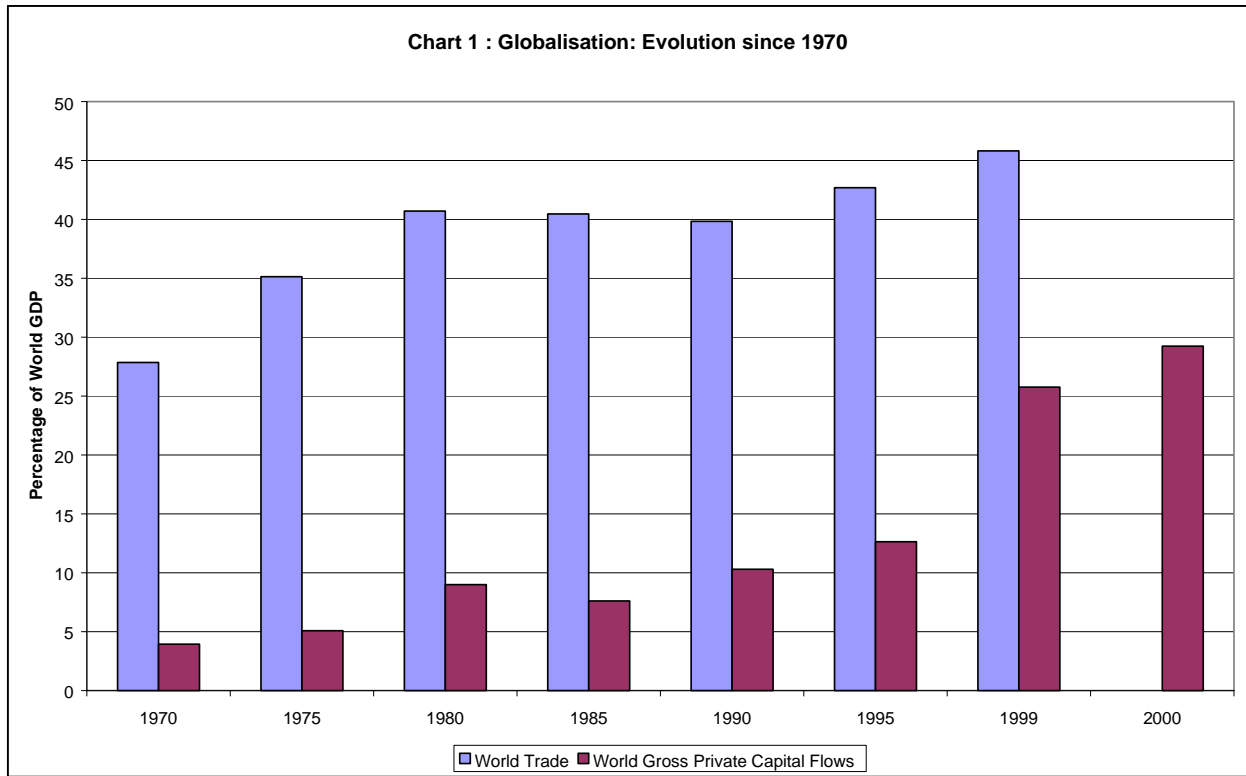
1.1 What statistics show

To consider the issues of trade openness and financial liberalisation it can be useful to look at how analysts measure them. The ratio of world exports (or world trade, i.e. exports and imports) to world GDP is used to see to what extent the economies are integrated. Similarly, international financial integration can be measured by the ratio of world financial trade flows to world GDP. Any increase in these ratios denotes a state of higher international economic integration.

During the past thirty years (1970-2000), both simple measures have increased significantly (chart 1), from slightly above 25% for trade to above 45%, and from less than 5% for financial flows to almost 30%. The integration process is visible, but not with a linear development: indeed, even during this short past period, there has been moments when both ratios decline (1985 against 1980, for instance).

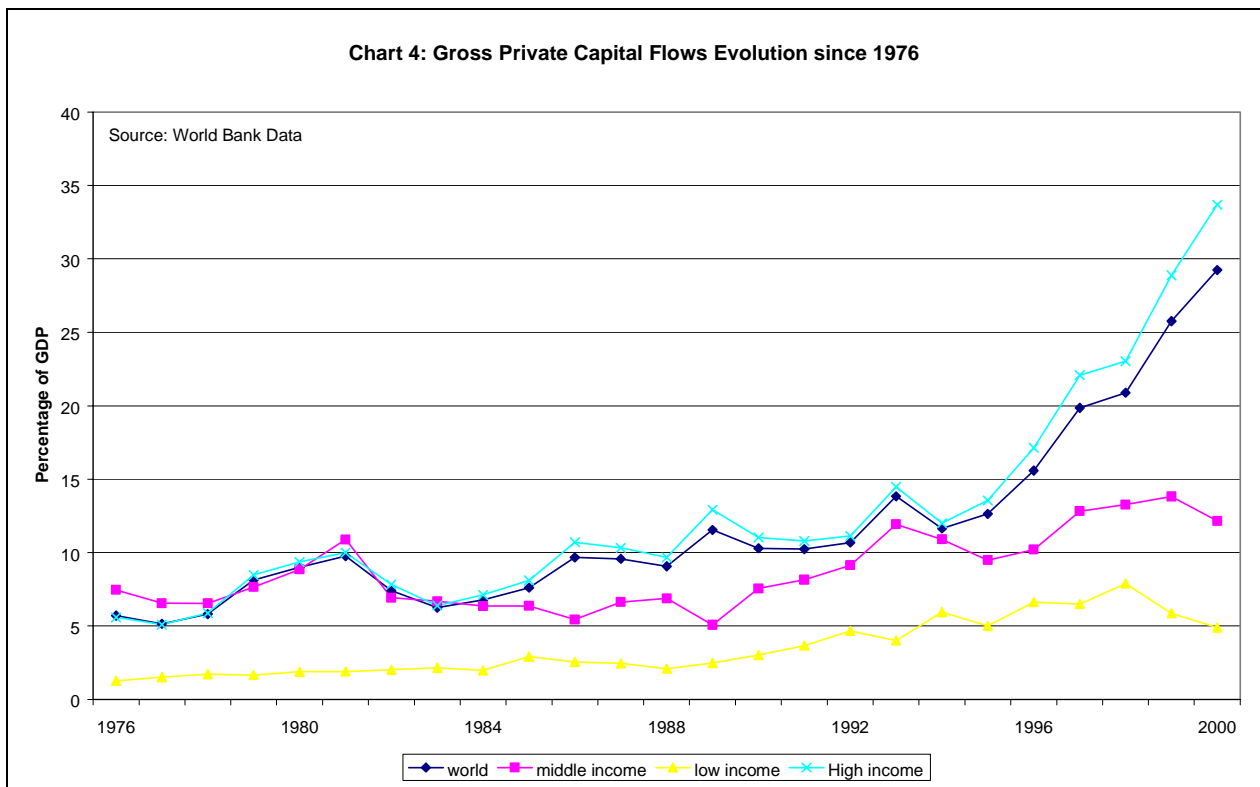
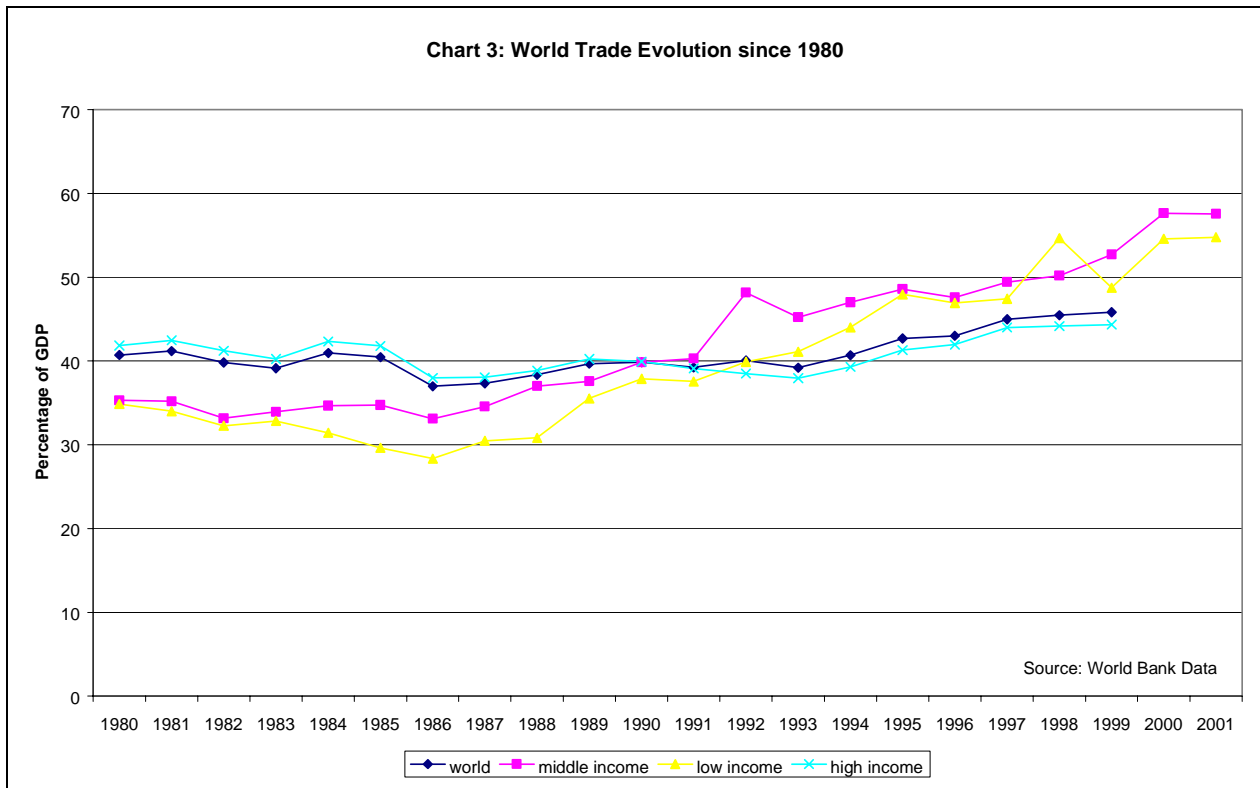
For trade measures, it is possible to use much longer dated information (chart 2), going back to the early 19th century². A very simple visual observation tends to show that there is indeed a secular trend in international integration, ultimately linked to the industrialization process and increased facilities for transportation and means of communication. However, the same visual observation would support the view that there can be quite long periods of international 'dis-integration': obvious during the Great Depression of the 30s, but with a recurrent 'gap' until the 90s. In other words, the rapid integration process observed first during the 60s, and second after 1980 could be considered as a delayed catch-up on the previous break in the secular trend. The current worldwide economic slowdown that has been under way since the end of 2001 will certainly lead to another relative decrease of world trade and financial flows, as it happened after the 1973-75 oil crisis and during the 1980's (the "lost decade").

² Derived from Angus Maddison 'Monitoring the World Economy, 1820-1992', OECD, 1995 and 2000, Paris



Moreover, it is interesting to note that countries do not have parallel evolutions as regards trade and financial flows. As charts 3 and 4 show it, while low and middle income countries have seen their trade as a percentage of GDP increase more rapidly than the world's and high income countries'

ones for the past ten years, on the opposite, they are lagging behind in terms of capital flows and this trend accelerated in the past eight years. Another striking point of these charts is the strong parallel between world's trade and capital flows figures and high income countries' ones, underlining the still predominant and leading role of high income countries in the world economy.



1.2 Integration and openness: two different concepts

Although the preceding measures acknowledge an overall growing integration of world economies, it is important to stress that commercial or financial integration do not necessarily mean trade openness or financial liberalisation. Indeed, many countries are much involved in world trade and financial flows, while their trade and financial policies are ‘protectionist’ or ‘strategic’ ones. Many Asian countries are good examples of this dissociation between integration and trade openness or financial liberalisation. South Korea has adopted at a very early stage of industrial development to use exports as a key engine for balanced growth, which translated into the rapid ‘integration’ of the country into world trade flows. However, the Korean authorities had a straightforward ‘industrial policy’ where imports were favoured or authorized only insofar as they contributed to the export performances, while any other imports were very severely discouraged through high tariffs and strict non-tariff barriers to trade. This ‘selective and strategic’ openness illustrates that free trade or financial liberalisation are not the only ways to world integration. As for financial liberalisation, China (or Malaysia, India and many others) do today impose some controls on capital flows, apparently not preventing these countries to be destination of choice for institutional or international investors, clearly putting them into the process of financial integration.

1.3 Trade Openness and Financial liberalisation: two sides of the same coin

A recent aspect of world exchanges is the fact that trade and financial flows are increasingly linked and tend to move more and more together. Many reasons can be put forward to explain this trend.

- Growing trade flows need to be financed by symmetric financial flows.
- The increasing number of foreign direct investments (FDI) has led to an integration through trade first and then through the enterprises. As multinationals and FDI developed, more and more funds were needed to finance them: international companies increasingly turned to banks and to the stock exchange to raise their necessary funds, thus leading to growing financial flows.
- The inclusion of services (GATS) within the WTO negotiations and liberalisation process enlarged the scope of trade openness and led to increasing financial flows...
- While globalisation is expanding, free trade areas are being created in parallel. This stronger integration between countries in a same geographical zone requires stronger financial integration between them as well (the creation of the European common currency is the most achieved example of this trend).

2- The Issues: a Step-by-Step Look

2.1 The Orthodox Theory

Most international bodies (WTO, IMF, World Bank...) strongly support the case for trade openness and financial liberalisation when setting up programs for developing countries or when multilateral meetings occur. This approach is based on the economic theory which states that trade and financial openness promote growth and higher standard of living in the country in which they are applied.

The arguments put forward are summarised in the table below:

Trade Openness	Financial Liberalisation
<ul style="list-style-type: none"> • Gains from specialisation in the good in which the country has a comparative advantage (productivity gains, lower costs of production...). • Innovation and efficient production in a smaller number of goods. The country can thus compete internationally. • Greater variety of goods available to consumers thus increasing the consumer surplus and satisfying the consumers' "demand of difference". • Adoption of sound policies to make sure the country is attractive to investors: trade openness acts as a watchdog for politicians as bad economic performances are blamed on them. Good governance should thus be fostered. 	<ul style="list-style-type: none"> • Capital flows can enhance domestic investment rates. From capital-rich to capital-poor countries, they can improve the rate of capital accumulation in the latter. • Well functioning financial markets are a means to mitigate risks through diversification and reduced transaction costs. Investment and higher growth are hence fostered. • Financial intermediaries can solve part of the imperfect information problem thanks to lower intermediation costs and stimulated information acquisition. Better resource allocation is then promoted. • Proportion of savings funnelled to investment should increase. • Better allocation of funds can raise the marginal productivity of capital.

Most international financial institutions and many influential economists share a view of a negative correlation between trade barriers and growth. Thus the OECD publication (1999) "Trade, Investment and Development: Policy Coherence Matters" contends that experience confirms that growth and poverty reduction performances in developing countries that liberalised their economies should be included among most remarkable episodes in the development history. Over a long period the open economies registered noticeably faster growth than those that remained restrictive in international trade regulation. According to the IMF (1997): "Policies toward foreign trade are among the more important factors promoting economic growth and convergence in developing countries". The (so far) unambiguous answer of the so-called 'orthodox' theory is that free trade (in goods and services, and to a lesser extent³ in capital) benefits all the countries involved in it.

For the economist, initial interrogations find their origins in the basic tenants of the orthodox liberalisation / integration, where key assumptions can be questioned as far as implication for the international economic paradigm is concerned:

- Most of the models in trade economy seek to maximise the representative agent's (usually the consumer) utility, which depends on an arbitrage between price and quantity. This is a strong reduction of reality since it has been acknowledged a long time ago that trade flows were mostly occurring between countries with similar comparative advantages, similar levels of development and between similar products (the European Union is a good example of this). Hence, other considerations have to be taken into account, like the consumers' demand for difference or the intra-firm trade (and not only the inter-firm one)...

³ Indeed, the IMF and other leading institutions have started to issue some cautionary notes on the benefits versus risks of financial integration and liberalisation (see bibliography)

- The models often assume that return to scale are constant. What if this were not the case? For instance, if return to scale were increasing in China, then as it opens up to trade and expands the scope of its economy, it would produce more and more thus reducing the gains from specialisation and openness in other (smaller) countries, instead of improving them.
- Game theory contends that as long as countries are not sure (simultaneous move game) whether their trade partners are actually going to open up or not, or what the free trade situation will mean for them (imperfect information), it might be optimal to remain in autarky (for instance if the cost of them opening while their trade partners do not is very high). In this case, the equilibrium achieved is not Pareto optimal (since world welfare would be enhanced with free trade). However, it is the best response the country can give owing to the information it has and to the fact it tries to minimise its loss. In this framework, opening-up to free trade in goods and services is not the optimal answer.
- The potential positive link between trade and innovation in a small economy is considered by Helpman and Grossman (1991). According to them, it depends on the direction of the country's use of resources, whether the activities they are allocated to are able to generate long term growth. A country with a significant technological lag may be pushed by free trade to specialise in the production of "traditional" goods, non- or low-manufactured ones. It may be forced to explore its initial comparative advantage in non-dynamic sectors, where country benefits will be diminished by the instability of world prices. Economists call this "a spell of natural resources" - countries with abundant natural resources concentrate on this simple comparative advantage and do not innovate. The virtuous circle of free trade is thus called into question if some conditions underlying in the theory are not fulfilled.
- The financial markets are often required to be efficient and "well functioning" in order for financial liberalisation to fully benefit the country. However, these usually imply good governance, a well-functioning legal system, proper infrastructures to convey the information... This raises the very important issue of what, from financial liberalisation and proper institutions, should come first in the development process.

The issues raised by the economic theory on trade openness and financial liberalisation, led economists to look at empirical analyses to compare facts and theory.

2.2 Empirical measures: issues and results

2.2.1 Statistics and measures: caution required

As in most empirical studies in economics the measurement problem is raised: which data to consider, how to measure the "openness" indicator, are data reliable...are redundant questions in the field. As early as in the 1950s, the Leontieff paradox was raised. Indeed, in his empirical study on the United States, the US exports were mainly made of labour, which was the scarce factor for this land- and natural resource- rich country. Was the whole theory of comparative advantage (where the abundant factor is supposed to benefit from trade) called into question? One solution to the paradox was found in dividing the labour input in skilled and non-skilled labour. At that time, the US was a skilled labour relatively richer country, hence it made sense it was exporting more skilled labour goods.

The issue is raised again in a recent paper by Rodriguez and Rodrik (RR) (2000), who examine several empirical studies considered to be the most influential in decision circles⁴. They present a number of criticism against those papers and their findings. Most methodological problems are related to the openness indicator definition. RR argue that often it does not properly measure trade barriers or is firmly correlated with other sources of bad economic performance. Average tariff rate is underweight by corresponding import levels, NTB coverage pose a problem of distinction between important barrier and those having no serious effect on trade level (unrealised quotas). RR's bottom line is that the link between growth and openness is far from being proved and they even question its mere existence at least for the level of trade restrictions observed in practice - differences between free trade and autarky are not analysed anymore.

Siroën (2000) comes back on this issue of trade openness measurability. Like RR, he stresses that the profusion of indicators can lead to question their actual use and reliability. On the other hand, it comes as a proof that the concept of trade openness is far from having a unique definition and that each of this indicator reflects a different approach of the concept.

Indeed, among all the different openness indicators (all differ because of data availability), one can mention some 'important' ones⁵:

- The IMF "Trade Restrictiveness Index", which measures a country's trade liberalisation or trade restriction policies.
- The US Tuck Research Center "Emerging Market Access Index"(EMAI) which measures the degree to which these countries have opened their borders to trade and the Fraser Institute "Economic Freedom Index" (EFI)
- The CEPII measure on "trade discrimination". The latter is presented by Gaulier (2001). It is based on the conviction that the presence of barriers to trade leads to distortions in the geographical structure of a country import suppliers. The higher the real barriers are, the fewer suppliers will be present on the market, since they have to be strong or motivated enough to overcome the restrictions. It permits to measure the real openness, that is to say practical effect of barriers since it is related to microeconomic cost associated with higher trade restriction, which discourages potential suppliers to be active on the importing country's market.

This plethora of measures to handle the trade and financial openness issues underlines that the link between trade openness, financial liberalisation and growth or development is not a simple one that can easily be quantified and modelled. Indeed, as can be seen in the following empirical studies, results differ from one case to the other, depending on the model's assumptions but also on the country or group of countries considered.

2.2.2 Empirical Validation: a Highly Balanced Approach

However, since these findings are also supporting the views of these organisations, one might want to look at other results to avoid possible positive bias in favour of trade openness and financial liberalisation.

⁴ Those are: Dan Ben-David "Equalizing Exchange: Trade Liberalization and Income Convergence," *Quarterly Journal of Economics*, 108(3), 1993, David Dollar, "Outward-Oriented Developing Economies Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976-85," *Economic Development and Cultural Change*, 1992, Sebastian Edwards, "Openness, Productivity and Growth: What Do We Really Know?" *Economic Journal* 108, March 1998, Jeffrey Frankel and David Romer, "Does Trade Cause Growth?" *American Economic Review*, June 1999, 89(3), Jeffrey Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity*, 1995.

⁵ They are mentioned in a study conducted by TAC on Vietnam, for the European Commission and Mutrap Vietnam: *The Factom Model, FDI Attraction Comparison and Trade Openness Measure*, June 2002.

Thus Gwartney *et alii* (2001) fully support the previous findings: they construct a Trade Openness Index (TOI) for 91 countries on a large period (1980-98). The higher the TOI, the more internationally open the country is. They found that countries with higher TOI also have higher GDP per person and faster growth than less open economies. They even contend that “a one-unit increase in the TOI over a long period increases growth by 0.21 percentage point”.

However, results are usually less bluntly positive. As emphasised by Isaksson (2000), financial development may trigger growth, but it is not sufficient to insure a decrease in poverty. For this goal to be achieved, some other features like rural development or focusing on labour-intensive technologies have to be included in the development strategies.

In their study on Bangladesh, Ghatak and Siddiki (2001) also find results which, though supporting the theory, stress mostly that the critical problem in Bangladesh for stimulating economic growth is the availability of funds rather than their opportunity costs. Moreover, in their endogenous growth model, the variable which has the highest impact on growth is actually the one controlling for human capital. Thus in their study, the quality of education appears more critical in the development process of Bangladesh than the variables controlling for financial deepening or real interest rates.

Similarly in their review of the literature on this topic, McLean and Shrestha (2002) stress that the hypothesis that financial liberalisation is good for growth is rarely acknowledged as such. Some authors find a weak relationship, some a positive one but only for developed countries and some none at all. The authors then turn to their own empirical analysis to assess whether financial liberalisation promotes economic growth, using capital flows measures (and not capital account liberalisation ones). They found that foreign direct investment (FDI) and portfolio inflows do tend to enhance growth (through increased domestic investment) while bank inflows (more volatile) turn out to have a negative effect on it. Their results also support the view that international trade has a positive impact on growth. It is interesting to note however that the result is not homogenous over the type of capital flows considered: while long-term investment, here FDI, have a positive impact on growth (through transfer of technological and organisational knowledge for instance), more volatile capital flows do not. Financial liberalisation appears as both potentially harmful and helpful, without the net effect of this two opposite forces being assessed and maybe being dependent on each country's economic situation.

Thus, almost all the previous articles give a balanced answer to the question: are trade and financial openness beneficial to growth. The answer is rather “it depends”: on the country, on the measure used, on the financial flows considered... The following articles insist on geographical and cultural specificities which make a successful model of trade and financial openness not necessarily reproducible to every place in the world.

Palmero (1999) looks at the relationship between trade openness and growth, focusing on the **Asian countries** case. She maintains that growth in these countries was supported much more by internal factors than by commercial exchanges. She first observes that for most of the Asian countries studied between 1970 and 1995, there is a negative correlation between openness rates and GDP growth rates as well as between economic specialisation in their comparative advantages and GDP growth rates. The hypothesis she then wants to test states that internal growth as well as growth in the country's geographic area are key elements fostering international trade. She finds that growth, exports and imports are primarily determined by political closeness, geographic distances and exports/imports abilities. On the contrary, openness rate and relative structure of the agricultural

employment have a dismal influence on the dependent variables (thus invalidating the basic comparative advantage theory). Finally the author emphasises that the studied countries also share several characteristics, which may have helped them in developing and taking advantage of free trade, but which are often overlooked when considering the openness / growth issue. These characteristics are, among others: strong governmental intervention in economic development, undervaluation of the domestic currency against the dollar, low tariffs on export-oriented imports but high ones on other imports, valorisation of human capital through education, trainings and promotion of R&D, strong social cohesion in the country... Thus this article highlights that the relationship between openness and growth is far from being a direct and simple one even in the often cited example of the Asian countries. Internal characteristics specific to the country as well as to the geographic area, are critical elements which played as important a role in the success of these countries as trade and financial openness did.

Rougier (2000) focuses on a different geographic area to look at the relationship between openness and inequalities: **Latin America**. He finds that inequalities in these countries tend to increase with greater land availability and/or natural resources. On the opposite, inequalities are negatively related to the capital to labour ratio and the education levels. Thus it appears that specific characteristics (here abundant natural resources) may, when trade openness occurs, exaggerate inequalities already present in these land-rich and feudal types of countries. Indeed, specialisation in commodities absorbs capital that could otherwise have promoted industrial development and decreases incentives to acquire qualifications here again delaying industrialisation. These characteristics specific to Latin America may explain why trade openness and financial liberalisation may not have fostered the expected greater growth and lower inequalities. Here again considering the initial situation of the country before opening up to international trade and financial flows appears critical. The initial availability of human capital is for instance particularly emphasised in this article. These findings highlight that the concept of “path dependency” should be accounted for in a country’s development strategy.

This idea that there would be one solution applicable to all countries regardless of their specificities is strongly criticised by Joseph Stiglitz in his recent book “Globalisations and its Discontents”, in which he questions the organisation of the world economy itself, in particular the orthodoxy of international financial institutions’ strategies. Apart from problems like the way transition was promoted by the IMF and the World Bank in post-communist countries or the aid “conditionality” principle, Stiglitz also considers the link between trade restrictions and growth. As he points out, the case studies of successful developing countries prepared by the World Bank show that support to trade and openness is an important growth factor. But he firmly contends that export promotion strategy and support to new domestic enterprises are the policies which actually spurred growth. Only in the cases where these trade policies were implemented, was liberalisation a success. Moreover, in all successful cases, liberalisation was associated with the respect of budgetary constraints, promotion of education, macroeconomic stability, creation of a strong technological base and egalitarian policies. Thus as in previously mentioned articles, Stiglitz does not favour trade and financial liberalisation for liberalisation’s sake. Rather, several other factors have to be present, accounted for and secured before considering opening up fully to international trade and financial flows. Since the relationship between openness and growth is not an automatic one, the liberalisation process should not be done hastily without considering each country’s specificities.

This diagnosis is similar to that of the OECD (1999), which sustains that success in other domains is necessary in order to profit from the liberalisation beneficial effects. Those domains are according to OECD: macroeconomic stability, sound financial markets, public affairs and companies healthy management, human resources development, environment management and

structural adjustment. Similarly in a very recent IMF working paper (2003), caution is put forward as regards “The Effects of Financial Globalization on Developing Countries”. As was presented above, the authors pursue a review of the economic literature on the link between financial integration and economic growth. Of fourteen papers reviewed, only three find that the effect of financial liberalisation on economic growth is positive, while four find no effect at all, five no effect or mixed results and one no effect for poor countries. These highly inconclusive results, though they do not necessarily question integration in the world economy *per se*, underline two important aspects of financial liberalisation:

- The effects of openness to capital push in opposite directions: while greater access to capital may foster investment and growth, it can also trigger greater economic turbulence which in turn may threaten growth. The net effect of these opposite forces, whether positive or negative is hard to detect beforehand.
- Financial integration will more likely be positive for the economy if certain conditions are previously met (sound macroeconomic policies, good governance, proper institutions and infrastructures, a sound banking sector, reliable rule of law...). The authors call it a “threshold effect”: it is only when countries have achieved a certain level of financial development (“absorptive capacity”), that financial liberalisation will support growth.

This highly conditional support for trade openness and financial liberalisation from the “real world” lead us to highlight why unprepared trade and financial liberalisation can indeed be harmful for the country in which it is implemented without considerations.

2.3 Why trade and financial openness could be harmful

Five reasons can at least be put forward to underline the potential risks in unleashed trade and financial liberalisation.

- Fluidity. All products do not have the same fluidity, meaning that some may be easily relocated while some others are ‘stickier’ and cannot be as easily moved. This is well acknowledged in gravity models which show that there are several factors that actually prevent trade and exchanges from being as efficient as they could. Distance and transportation costs are important hindrances, but linguistic, legal, cultural, historical and political links also play an important role as well as the home country bias (the fact that larger countries tend to be exporters of a product, *ceteris paribus*, since the larger market attracts firms to locate there). All these factors potentially reduce bilateral trade and can even make liberalisation a failure (if the exporting firm is not prepared enough, or faces unexpected “social” resistance to its products...).
- Multiple comparative advantages. As many countries with similar resources are opening up to trade, they bring at the same time their same comparative advantage on the market. This will create an excess supply of that product and its world price will decrease, thus harming all the providers. This decreasing trend in the countries terms of trade occurred for developing countries exporting raw materials. They had to increase their production if they wanted to keep the same level of export revenue, thus accentuating the phenomenon. Similarly, the Asian countries, which comparative advantage was cheap and abundant labour are now facing greater competition from each other and from China, pushing them to find out new differentiation possibilities. Both examples show that as openness becomes more and more widespread, countries cannot rely on a single comparative advantage to support their economic development: diversification should be promoted as well in order to face the issue of multiple comparative advantages, rising competition and lower prices (i.e. lower revenues from trade, *ceteris paribus*).

- Instability as regards financial volatility. Implementing financial liberalisation implies allowing financial flows to freely move in or out of a country. However, in a country which lacks political credibility or monetary strength and power, capital mobility and volatility can make economic policies useless, thus preventing a country from using fiscal or monetary tools to try to solve domestic economic problems. This means greater dependence on the international environment.
- Investors' size versus market size. If concentration on a small market is high, the issue of market efficiency becomes critical. Indeed if one of the large and few investors on a small market withdraw its funds, it can threaten the whole market equilibrium, and even create panic among other investors without any "fundamental" reasons behind it.
- Timeframe. A country's development process is a long-term one, while financial investors usually have a short-term approach. Thus there are potential conflicts of interest between public authorities and private investors/companies, which can be harmful for development goals. This is especially true for financial flows, which show cyclical evolutions on a long-term pattern. Thus as financial globalisation is not an irreversible phenomenon, countries should be cautious in relying too much on them for a sustained growth. Moreover, countries lacking the proper financial development (as is often the case in developing countries), the downturn is even worse than in developed countries. These aspects speak in favour of a timely managed financial liberalisation.

3- Attempt of conclusions

As both theory and empirical studies show, the relationship between trade/financial openness and economic growth is, at best, ambiguous when considering the macroeconomic level of the countries' economies. On the contrary, many microeconomic agents are unambiguously benefiting from greater economic integration between countries, from wider liberalisation and from diminishing barriers in both trade and financial flows. Large multinationals and export-oriented companies did take advantage in the world openness' increasing trend, at the expense of domestic employment and/or uncompetitive companies that were not able to face increasing international competition. However, it is not obvious whether a country will overall benefit from liberalisation or not. Thus because of this ambiguity and this dichotomy between the macro- and micro-levels, the liberalisation question remains a specific one, which ought to be dealt with case by case.

Indeed, as almost all reviewed articles contend it, the relationship between growth and openness (trade and financial one) is highly conditional on a country's pre-existing circumstances (economic, historic, cultural or geographic specificities...). This approach in terms of "path dependency", highlights that the schedule (i.e. the chronology) of the country's opening up to trade and financial liberalisation is critical for it to be successful. Some characteristics (macroeconomic stability, credibility in government's policies, reliable legal institutions...) should be fulfilled first before removing all trade barriers, in order to make liberalisation as little costly, socially and economically, as possible. The Indian reluctance in fully liberalising its financial sector is, for instance, presented as a means for promoting greater efficiency in the sector so that it can better face international competition once full liberalisation occurs.

Finally, if chronology is key for liberalisation to actually benefit countries, it also means that openness is not the only factor able to promote growth and development. Indeed, factors like widespread and non gender biased education, good infrastructures, credible, reliable and secured

legal and political institutions are factors that should be given priority over liberalisation since they are some of the conditions for the country to achieve the economic maturity that will allow it to face liberalisation as best as it can. Development is a long-run process and setting-up proper institutions takes a long time and the examples of Russia, Argentina, many African countries and some Asian countries show that too fast a liberalisation process can be very costly and damaging socially, economically and environmentally. This starts being acknowledged in some international organisations: thus at the WTO, different treatments were granted to the organisation's members depending on their development levels, supporting the idea that some other factors are more important than a full liberalisation, at least at the beginning. But this implies that the rules of the game are respected by all players (which is not the case when considering non-tariff barriers, dumping procedures...).

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