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Institutional Motives for Forming FTAs: The Contradiction between the MFN Principle and Reciprocity

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Introduction

The General Agreement on Tariffs and Trade (GATT)¹ was established in order to substantially reduce tariffs and other trade barriers and to eliminate discriminatory treatment in international trade in general. In fact, the GATT and its successor, the World Trade Organization (WTO), have played key roles in managing the international free trade system. Non-discrimination is the fundamental principle used to achieve these free trade objectives under the GATT/WTO framework, and this principle is embodied in the unconditional most favored nation (MFN) clause under Article I of the GATT agreement. The WTO has continued to maintain this principle of non-discrimination, and unconditional MFN clauses still play an important role in bringing about multilateral trade liberalization.

In recent years, however, there has been a global trend towards forming, or starting consultations on forming, bilateral and regional free trade agreements (FTAs). Article XXIV of the GATT agreement allows for free trade areas as one of the exceptions within MFN obligations, because they are expected to complement the WTO liberalization process. But it is a fact that FTAs are by nature reciprocal and preferential. Indeed, it is impossible to ignore that FTAs have the potential to dilute the function of unconditional MFN clauses. Even though FTAs are exceptions to the unconditional MFN clause as a matter of form, policy makers who are paying attention to FTAs seem to regard them as an alternative to the WTO for promoting trade liberalization. This proliferation of FTAs, or FTA thinking, raises important questions: Why are so many states opting to form FTAs now? Are there any factors in the GATT/WTO system itself that are pushing countries toward

FTAs? Does multilateral liberalization based on the non-discrimination principle no longer function efficiently?

In order to consider the institutional motives for FTAs in the WTO system, it will be necessary to examine the nature as well as the function of the principle of unconditional MFN treatment. As such, this chapter will look at the development process of MFN treatment, the ways in which states seek to form reciprocal relations by exempting themselves from MFN obligation in the multilateral trading system, and the reasons why states have opted for FTAs after the Uruguay Round.

The Development Process of MFN Treatment

A Definition of MFN Treatment

MFN treatment generally obliges the parties to grant each other existing and future concessions given by either party to any third party. This concept of MFN treatment consists of three essential elements: that concessions should be granted reciprocally; that concessions should include not only existing privileges but also future ones; and that concessions should include all favors that are given by either party to any country. However, reciprocity is not inherent in MFN treatment. It was only after the mid eighteenth century that the notion of reciprocity was inserted into MFN treatment. The incorporation of reciprocity into MFN treatment divides MFN clauses into two types: an unconditional MFN clause that extends favors without a reward and a conditional MFN clause that requires equivalent compensation. The distinction between unconditional MFN treatment and conditional MFN treatment can be explained as follows: Under an unconditional MFN clause, a country is prohibited from discriminating against any country with which it has an agreement to grant MFN treatment. Thus, if a country *A* and a country *B* agree upon an exchange of concessions based on unconditional MFN treatment, and *A* then makes new concessions to a country *C*, *A* should also automatically apply these concessions in its dealings with *B*. If *A* and *B* agree upon a conditional MFN clause, however, *B* can receive those concessions only when *B* provides *A* with compensation equivalent to that offered to *A* by *C*.

Each of these two types of MFN treatment is theoretically based on a different notion of reciprocity. Unconditional MFN treatment is supported by "diffuse reciprocity." In contrast, conditional MFN treatment is derived from "specific reciprocity."² Essentially, reciprocity can be defined as a fundamental

rule through which plural parties maintain a balance of treatment by granting the same or equivalent rights and benefits or by fulfilling obligations to each other (Yamamoto 1988: 245). A reciprocal relationship can be explained as a balanced condition in which one side gives the other certain treatment while the other returns equivalent treatment (Kuwahara 1975: 417).³ Keohane (1986: 5) extracts two essential elements from reciprocity, contingency and equivalence. According to Peter M. Blau (quoted in Keohane 1986: 5–8), reciprocity implies “actions that are contingent on rewarding reactions from others and that cease when these expected reactions are not forthcoming.” Reciprocal relations require antecedent actions of one side that induce the other to act in consequent response.⁴ On the other hand, an equivalence of benefits is emphatically associated with the notion of reciprocity, even though measuring such equivalence is difficult in the context of international relationships.

The different notions of reciprocity are distinguished according to which element of reciprocity draws more attention. Diffuse reciprocity puts importance on contingency, while specific reciprocity requires equivalence. The notion of diffuse reciprocity implies broad coverage and a long-term relationship. This type does not demand any direct response to an antecedent action; it merely imposes on the receiving side a certain obligation for repayment in the future.⁵ Consequently, diffuse reciprocity leads to unconditional MFN treatment. On the other hand, specific reciprocity places greater emphasis on a simultaneous exchange of strictly equivalent benefits or obligations. Specific reciprocity brings forth conditional MFN treatment, which is suitable for bilateral or limited relationships.

Functional Change of MFN Treatment

An Incipient Stage: Generalizing Concessions

The embryo of MFN treatment can be found in the feudal age—from the eleventh to the thirteenth centuries—as lords granted equivalent concessions to merchants of different foreign cities.⁶ These privileges were unilaterally granted by a lord to citizens outside his territory, and the favors were limited to those privileges already granted to others.

After the fifteenth century, the concept of MFN treatment developed together with sovereign states and ideals of equality advocated at the time. As the scope of commerce increased amongst European nations, the use of MFN clauses in bilateral commercial treaties also increased. Until the second half of the seventeenth century, MFN clauses generally obliged the

contracting parties to grant each other existing and future concessions given by either party to any nation.

MFN clauses became widespread throughout Europe from the late seventeenth to the early eighteenth century, partly because mercantilism—upon which most European states based their trade policies—meant that trade was promoted in order to develop domestic industry.⁷ Each sovereign would conclude preferential treaties with foreign states to gain market access with more favorable conditions than others. It became standard practice to stipulate the inclusion of this preferential treatment in commercial agreements; however, sovereigns became concerned about future discrimination. For instance, a sovereign *A* (having already entered into a preferential agreement with a sovereign *B*) may seek to obtain the trading benefits that *B* had offered to a third party (subsequent to signing a treaty with *A*). Under these circumstances, *A* may prefer that the benefits which it offers in future to a specific third party through another treaty also apply to *B*. This is to ensure that *B* also extends future favors offered to a third party to *A*.

Even though mercantilist ideas exercised considerable influence on the development of MFN clauses, a more important factor accelerating their evolution was the formation of the tariff system (Murase 1974: 61–62). During the Middle Ages, feudal domains used various kinds of duties and taxes. As Europe shifted from a social system based on the coexistence of many feudal lords into one of nation states, these new states began to integrate local duties into single tariff systems within their own territories. Because imposing tariffs and regulations on imports was regarded as a sovereign right and because tariffs were necessary to protect domestic industries and gain national revenue, sovereigns unilaterally established and revised tariffs depending on the circumstances. However, as tariffs were raised by one state, others retaliated, which led to tariff wars. Eventually, states came to control tariff rates through bilateral agreements, which made it impossible to change rates unilaterally. This led to the creation of a conventional tariff system. This system meant that, when a state revised the tariff rates of a certain agreement, it had to modify all other agreements on tariff rates. States also feared overlooking concessions when making treaties. Consequently, alternative MFN clauses were devised that could avoid such repetitions and assure partner states that the benefits of previous or subsequent concessions made to third states would also be provided to them automatically (US Tariff Commission 1919: 17).

At the time, MFN clauses functioned to generalize concessions. However, because MFN clauses were inserted into treaties with specific states, it was not possible to secure non-discrimination in the same sense that operates in

the present multilateral trade system. Instead, the clauses often worked as a means to discriminate against states that had not concluded commercial treaties.

A Development Stage: Protecting National Interests through Reciprocity

The function of MFN clauses drastically changed when the conception of reciprocity was inserted. It was the United States that brought reciprocity into trade policy. After gaining independence, the United States signed the first commercial treaty in 1778 with France, a treaty which contained provisions for reciprocal trade concessions in order to ensure a free flow of goods and ships. The principle of reciprocity embodied in the MFN clause of Article II read as follows:

The Most Christian King and the United States engage mutually not to grant any particular favor to other nations in respect of commerce and navigation, which shall not immediately become common to the other party, who shall enjoy the same favor, *freely, if the concession was freely made, or on allowing the same compensation, if the concession was conditional* [Hornbeck's italics].

(Hornbeck 1910: 14)

Until this time, the customarily used MFN clause would have had no limitations extending to the other original party in terms of concessions later granted to a third state. Such a practice remained in the clause with the words "freely, if the concession was freely made." However, the phrase "on allowing the same compensation, if the concession was conditional" indicated the insertion of a reciprocal principle into MFN treatment. Under this provision, if the United States made new concessions to any third party, France could receive these concessions only when it provided the United States compensation which would be equivalent to that offered to the United States by the third party.⁸ Simply, it was explicitly stipulated that the favors granted to any third party could not be automatically extended between the two initial parties to the MFN clause, a stipulation which afterwards came to be known as a conditional MFN clause.⁹

The United States used reciprocity in its commercial policies in order to open up foreign markets and secure equal opportunities in these markets. Through this new MFN clause based on reciprocity, the United States was able to benefit when the partner country reduced tariffs on US goods as a reward for US tariff reduction on goods from that country.¹⁰ The US commercial

treaty-making policy attached much importance to "bargaining between individual nations on the basis of reciprocal and progressive giving of favor for favor and concession for concession" (US Tariff Commission 1919: 39).

When the conditional MFN emerged, it became the main tool stipulating MFN treatment in commercial treaties. However, this did not mean that unconditional MFN clauses were out of date. Conditional and unconditional clauses alternated as the most widely used MFN clause. Conditional MFN clauses were effective for obtaining foreign market access while protecting domestic industries. On the other hand, unconditional clauses were potentially useful for maintaining an open and free world trading system. Interestingly, the dominant states in world trade have tended to prefer unconditional MFN clauses: the two most obvious examples being the United Kingdom during its Pax Britannica period and the United States during Pax Americana.

In 1860, the United Kingdom and France concluded the Cobden-Chevalier Treaty, which substantially reduced tariffs on some goods and removed prohibitions on exports and imports between the two countries.¹¹ In Article XIX of this treaty, the United Kingdom and France also secured MFN treatment without conditions. The Cobden-Chevalier Treaty had a great impact on other European states. Most of the European states with commercial policies leaning toward free trade found it would be beneficial to participate in a free trade alliance between the United Kingdom and France and expressed a preference for concluding commercial treaties that included an unconditional MFN clause.¹² As a result, unconditional MFN clauses became the common practice in European commerce. Indeed, an elaborate system of agreements emerged between several European states¹³ and European trade flourished.¹⁴

Another country utilizing unconditional MFN clauses was the United States. Between 1934 and 1945, every bilateral trade agreement made by the United States with twenty-seven countries contained unconditional MFN treatment.¹⁵ All of these agreements were based on the Reciprocity Trade Agreements Act (RTAA), which was enacted in 1934 and allowed the United States to change the basis of its trade policy from protectionism to liberalism (Gilligan 1997: 62–73; Tasca 1938: 10–28).¹⁶ The United States used the unconditional MFN treatment as a countermeasure against the other major states, which tended to enclose their economies within the walls of preferential or imperial trading blocs. With unconditional MFN treatment, the United States could secure equal treatment to other competitors in its trading partners' markets.

Although the dominant perception of MFN treatment has at times swung cyclically between conditional and unconditional clauses, both forms have

been unquestionably reciprocal in nature. Conditional MFN clauses were devised and spread because they protected the national interest through specific reciprocity. In contrast, the advocates of unconditional MFN clauses could utilize them as a tool to keep their trade partners' markets, by exchanging concessions as long as a relevant agreement existed, even though such concessions were not symmetrical. The principal objective behind the use of unconditional MFN clauses in trade agreements was to avoid future discrimination by the other party to an agreement as a result of that party granting third parties more favorable treatment. Unconditional MFN clauses could preserve most favored status in the future for each party to an agreement without requiring further compensation. It was enough to agree initially to the extension of unconditional concessions.

Contingency and equivalence were indispensable aspects of reciprocity, but there was no need to attach the same weight to both sides. The parties to a trade agreement were free to make a wide range of demands concerning the envisioned compensation. As long as the decision whether to grant unconditional MFN treatment to some state could be made case-by-case, unconditional MFN treatment could be compatible with reciprocity. It was not strictly speaking specific reciprocity but rather diffuse reciprocity.¹⁷ In this way, the function of MFN clauses consequently changed from the earlier period. While unconditional MFN clauses could still act as an instrument to generalize concessions secondarily, conditional MFN clauses no longer played such a role.

Under the GATT System: Realizing Non-discrimination

The GATT system was established in order to proscribe the discriminatory trade treatment that had caused international trade to develop into economic blocs. The GATT, therefore, emphasized the principle of non-discrimination in trade. This principle was further divided into two parts: external non-discrimination prescribed in Article I and internal non-discrimination prescribed in Article III.¹⁸ Article I stated that "any advantage, favour, privilege or immunity granted by any contracting party to any product originated in or destined for any other country shall be accorded immediately and unconditionally to the like product ... of all other contracting parties." This exactly matches the terms of unconditional MFN clauses and proscribes bilateral or regional tariff preferences.

At the same time, the GATT superseded a series of reciprocal bilateral trade agreements, most of which, especially those concluded between European states, contained a conditional MFN clause. However, these clauses were not incorporated into the GATT agreement. The reason for this

was because the United States, which took the initiative in trade negotiations during World War II and its aftermath, pushed for the adoption of an unconditional MFN clause in the GATT agreement (Milner 1997: 138–39). During this period, the United States firmly advocated that commercial policy should be non-discriminatory. It recognized that flourishing international trade was vital to its domestic prosperity (Tasca 1938: 39) and considered making the world trade system more open and free as a necessary step to suppress economic nationalism, which had contributed to the breakout of World War II, and thereby help prevent future military conflict. Furthermore, the United States deemed that a conditional MFN clause would bring discriminatory reciprocity and was actually employing unconditional MFN clauses in its bilateral trade agreements at the time. Thus, an unconditional MFN clause was incorporated into the GATT agreement, which was conceived as the most effective measure for applying the non-discrimination principle to actual trade practices.¹⁹

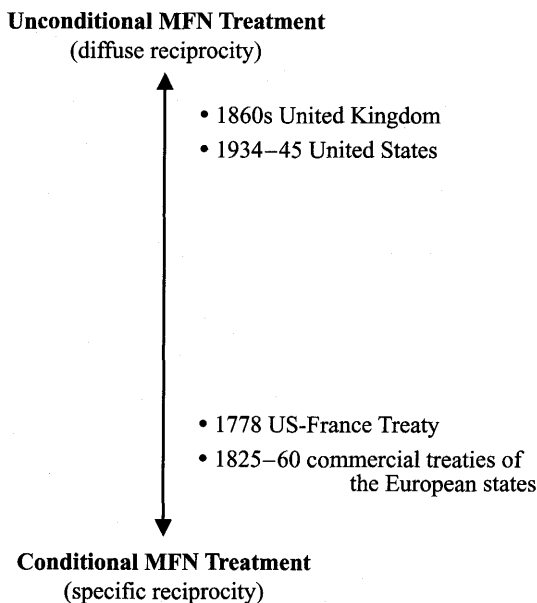
Change in the Nature of MFN Treatment

The adoption of unconditional MFN treatment in the multilateral trade system not only changed the system's function but also its nature. Before the GATT was established, when bilateral relations governed the world trade system, MFN clauses, even in an unconditional form, sustained a reciprocal feature in international trade. For instance, the United States selectively concluded commercial agreements containing unconditional MFN clauses with the countries from which it could expect a response, regardless of whether the exchange was simultaneous and equivalent. Unconditional MFN clauses in US bilateral trade agreements were not aimed at securing equal treatment with all trade partners in its market, but were aimed instead at protecting US exporters from discriminatory treatment in the future.²⁰ Therefore, it was of no significance for the United States to get simultaneous and equivalent responses. This attitude conforms to the idea of diffuse reciprocity.

Historical examination shows that conditional and unconditional MFN treatment (in other words the idea of specific reciprocity and diffuse reciprocity) prevailed alternately until the GATT was established. Viewed in this light, it could be said that there existed only one axis to describe the trade policy orientation of each state at any given time: the axis indicates the component of reciprocity upon which a higher value is placed (FIGURE 3-1).

In contrast, unconditional MFN treatment in the GATT system has lost its reciprocal character owing to the fundamental change in its function. This

FIGURE 3-1
 VARIATION OF MFN TREATMENT (PREWAR PERIODS)



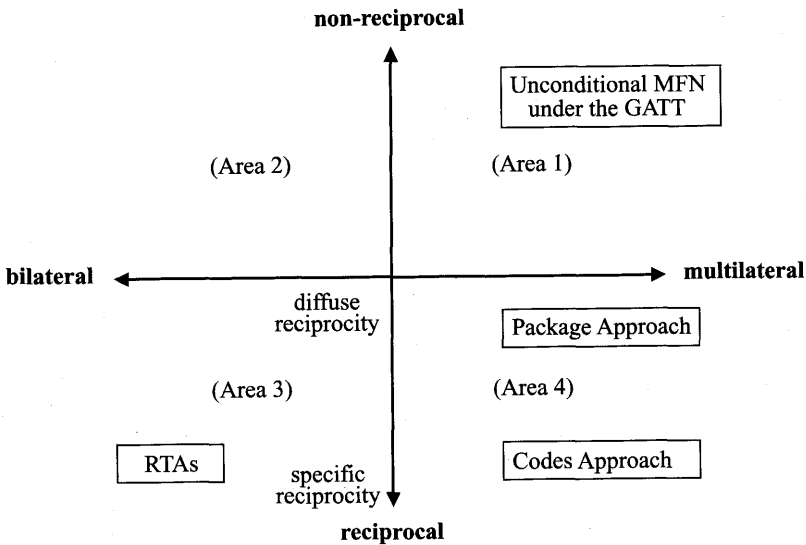
Source: Author.

change can be explained as follows: as trade policy is essentially a tool used to pursue national interests, trade liberalization is often conducted not through unilateral action but by bargaining with states in order to gain maximum benefits. Thus, agreements on the exchange of concessions are generally reached as a result of negotiation, and all such agreement-making processes are governed by reciprocity. A state lowers its trade impediments with the expectation that others will make consequent and equivalent responses. In the GATT system, however, once the agreements are concluded by reciprocal negotiations, such reciprocal exchange of concessions should be automatically multilateralized through an unconditional MFN clause. This extension of concessions to all other GATT members is not reciprocal but unilateral. That is, the side that makes concessions based on an MFN clause cannot necessarily expect a return from the other side. In this sense, the reciprocal aspect of unconditional MFN treatment, which efficiently operated in bilateral relations, cannot work any more under the GATT

system. This means that the unconditional MFN clause in the GATT agreement differs fundamentally from the one that was employed by the United States in its bilateral trade agreements in the prewar period, even though the same name is used to describe both terms.

The new characteristic of MFN treatment under the GATT system brought trade policy orientation into a new dimension. As trade negotiations expanded multilaterally after the launch of the GATT, a pair of axes can be envisaged: one is the traditional scale of reciprocity and the other is the scale of the number of parties. In addition to this shift toward a double parameter, the traditional axis has extended from the width of “specific reciprocity and diffuse reciprocity” to “reciprocal and non-reciprocal” (FIGURE 3-2). As a result of the dimensional expansion, policy orientation has shifted from the traditional alternate cycle towards a “mosaic” of areas on these two axes. An unconditional MFN clause under the GATT system is placed on Area 1 of FIGURE 3-2, which implies that its nature is non-reciprocal and it operates in multilateral relations.

FIGURE 3-2
TRADE POLICY ORIENTATION UNDER THE GATT/WTO FRAMEWORK



Source: Author.

The non-reciprocal nature of an unconditional MFN clause does not mean that the GATT ignores reciprocity. Both the Bretton Woods Conference and the preamble of the GATT agreement took account of reciprocity.²¹ From an historical viewpoint, moreover, MFN treatment has functioned with a reciprocal feature for more than two and a half centuries. It is only for fifty-odd years, after the establishment of the GATT, that MFN treatment has been connected with the non-discrimination principle. But approaches to trade negotiations could not change immediately. In fact, tariff reduction on the whole was made through bilateral negotiations based on reciprocity in the early GATT trade rounds. In the multilateral trade system, an incongruity between the non-reciprocal nature of an unconditional MFN clause and the practice of trade liberalization through reciprocal bargaining resulted in problems.

Reciprocal Practices under the GATT/WTO System

The new task of making unconditional MFN treatment operate in a multilateral trade system, as opposed to more straightforward bilateral relationships, led to various difficulties. As mentioned above, such problems originated from a latent contradiction between two core principles of the GATT: non-discrimination and reciprocity. When member countries came to recognize that the GATT system with an unconditional MFN clause could not assure reciprocal benefits in every action involving trade liberalization, some began to seek other measures through which they could expect reciprocal relationships.

A Package Approach

First, there was a problem of free riding. In the GATT agreements, the unconditional MFN clause prescribes that any bilateral agreement should be applied to other member countries. This implies that states signing the GATT agreement could take advantage of benefits without any binding agreement with others.

The principal mechanism of the GATT for addressing the reduction of tariff levels and other trade impediments is the *multilateral* tariff/trade negotiations (MTNs), referred to as "trade rounds."²² However, at the early trade rounds, negotiations were multilateral only in name. In reality, they were conducted bilaterally between the principal supplier states and principal consumer states based on specific reciprocity, a process which was referred

to as the request-and-offer approach (Winham 1992: 53; Enders 2002: 93–94). Given that trade rounds were governed by bilateral negotiations, free riding became more problematic.

It was already recognized in the draft negotiations of the GATT agreement that the strict application of an unconditional MFN clause would inevitably induce free riding. For example, the Brazilian delegation pointed out the potential incompatibility of the two goals and asked for an agreement whereby “reciprocity” would be considered more important than “non-discrimination” (Hudec 1991: 175). The United States, which played a leading role in the negotiations, tolerated free riding at first because the costs of coercion and policing free riding were believed to outweigh the benefits that would come from more stringent enforcement (Krasner 1987: 1). Instead, it put priority on entrenching the non-discrimination principle. Consequently, the free riding problem went unheeded during the early period of the GATT.

As member countries increased, however, the negotiations became more complicated. Complaints about free riding were raised by some states that were required to reduce tariffs after negotiations. In addition, the United States itself could no longer permit free riding because it had to tackle economic stagnation at home and the relative decline of its economic power abroad. Moreover, because free riding was overlooked, trade liberalization was more likely to decelerate. As Davey and Pauwelyn point out:

[F]ear of what they view as excessive free-riding may cause major trading nations to agree to less liberalization than they would if reciprocity were required. Again, the result may be fewer concessions if unconditional MFN treatment is required.

(Davey and Pauwelyn 2000: 15)

Then, member countries began to seek measures that could preclude free riders from taking part in multilateral negotiations. Two measures could be considered for resolving the problem: first, to renounce unconditional MFN treatment; and second, to reinforce the application of reciprocity by altering GATT procedures. But the GATT could not modify its fundamental principle of non-discrimination. Therefore, it tried to minimize the cost of unconditional MFN treatment by changing the operational procedures of negotiations.

After the Kennedy Round (1964–67), the GATT introduced a “package deal” into the decision making process that effectively excluded free riders.

The GATT not only obliged all the member countries to participate in consensus building, but also decided to deal with the whole problem as an integrated package. This operational technique developed into a "single undertaking" procedure at the Uruguay Round (1986–94).

Under this "package" approach, the kinds of benefits exchanged in the negotiations are unimportant. It is considered enough if one side provides certain liberalization favors and the other side responds with a commitment to provide other liberalization favors. Accordingly, it becomes essential that all member countries participate in the negotiations and make some sort of commitment. In this sense, the package approach is based on diffuse reciprocity.

Multilateral Codes

The second measure to ensure reciprocal treatment under the GATT system was a "code" approach. At the Tokyo Round (1973–79) of GATT negotiations, the main agenda, in addition to tariff reduction, included non-tariff barriers (NTBs) that covered sectors such as government procurement, customs valuation and standards. Even though a series of multilateral agreements on NTBs, so-called "Codes," were adopted as a result of the Tokyo Round, these Codes were separated from the GATT agreement.²³ Participation in these Codes was optional and the Codes only applied to those countries that chose to sign. As a result, each Code had a separate signatory that complicated the system. In fact, most developing countries abstained from signing the Codes.

This approach was taken because of the attitude of the United States. During the 1960s the United States tolerated a number of market-distorting measures employed by other GATT member countries, mainly by the European Community and Japan which could achieve high economic growth. The economy of the United States had been strong enough to absorb whatever kind of the negative impacts caused by anticompetitive behavior. However, the collapse of the dollar in 1971 brought about "serious economic distress and instability ... and declining power of the world's hegemonic state" (Milner 1993: 142–43). This made the United States call for a new trade policy which could protect national interests through reciprocal treatment. The United States found itself unable to obtain all the benefits expected from non-discriminatory liberalization and, therefore, began to put more emphasis on alternative approaches based on specific reciprocity. As such, within the framework of the GATT, the United States advocated more precise and binding rules in areas of concern and a

mandatory mechanism to enforce rules. The former resulted in multilateral Codes in some NTB matters at the Tokyo Round, and the latter led to functional reinforcement of the dispute settlement body.²⁴

The code approach satisfied the desire of the United States to set down specific rules and to enforce them vigorously among concerned members without a time-consuming packaged negotiation process. Hudec wraps up the benefits of the code approach by saying that:

- Governments had been able to make the code effective among themselves, without a two-thirds vote of all GATT members. The signatories were also able to administer the rules among themselves and by themselves. Because it was limited to those willing to accept the new obligations, the committee of signatories was a much more cohesive group and, therefore, it was more easily capable of reaching consensus;
- It is probably fair to say that the main reason for the code approach was simply the desire to escape from the cumbersome ratification procedures of the formal GATT amendment process. A closer second, however, was the desire to protect the enterprise from a developing-country veto. The new rules would go into effect with, or without, the blessing of the developing-country bloc.

(Hudec 1987: 82, 84)

However, it became doubtful whether such an approach was consistent with unconditional MFN obligations. Directly after the Tokyo Round, the GATT members reaffirmed that the Codes did not affect unconditional MFN treatment under Article I (GATT 1979), which implicitly showed a latent breach of the GATT agreement. Jackson (1983) discusses the issue of consistency between the NTB Codes and the non-discrimination principle, stating that the signatories of the Codes should extend the benefits under the Codes to non-signatories. However, in reality, only those signatories of the Codes would enjoy the benefits. Though Cline (1982: 19) states that it was ambiguous whether even these Codes departed from unconditional MFN treatment, the NTB Codes of the Tokyo Round were a *de facto* exemption from MFN treatment.

Aside from the consistency of NTB Codes with the MFN principle, it is obvious that NTB Codes were negotiated on the basis of reciprocity. Through interviews with trade officials, Finlayson and Zacher describe this point as follows:

Commercial policy officials have testified that the expectation that all major

trading powers had to offer roughly comparable concessions exercised a tremendous influence in negotiations of the NTB codes during the Tokyo Round. Although the difficulties of measuring reciprocity were magnified in the case of NTB negotiations, no one was prepared to abandon the concept. (Finlayson and Zacher 1981: 577)

Moreover, as Hafbauer, Erb and Starr (1980: 66) comment, it is not the unconditional but “[t]he conditional MFN concept [which] plays an important role in the disciplinary framework established in the Tokyo Round.” That is to say, the NTB Codes are measures based on specific reciprocity in multilateral relations (see FIGURE 3-2).

RTAs as Preferences

The third measure was the utilization of a regional trade agreement (RTA). The word RTA, though not itself part of Article XXIV, is the WTO term that covers customs unions (CUs) and free trade areas as provided in Article XXIV. Even interim agreements leading to the formation of CUs or free trade areas are included in this provision. This approach can be distinguished from the others by its “built-in” feature. RTAs are formally stipulated as exceptions to MFN obligations in the original GATT agreement, while both the package approach and multilateral codes were devised *a posteriori* in the GATT process.²⁵ It would be useful to look briefly over the drafting process of an RTA provision in order to clarify RTA characteristics and to understand the causes of current problems regarding RTAs.

The Drafting Process of RTA Provisions

The GATT agreement was drafted under the belief that preferential treatment systems discriminating against third parties should be ultimately abolished. This idea has its origins in the bitter experience of the economic bloc trading system, which contributed to the onset of World War II. Thus, the GATT strictly confines preferences to the practices existing when it was established.²⁶ This means that the GATT would not in principle permit the creation of any new preferences. Only three forms of exceptions are provided in Article XXIV: traffic frontier, a CU, or a free trade area. Such a preference could be allowed “if its economic impact on the world economy as a whole is positive, increases world welfare, and is a movement toward free trade” (Huber 1981: 294). As to frontier traffic and CUs, they have traditionally been recognized as exemptions from MFN obligations in many bilateral commercial agreements for more than two hundred years. At the drafting process of the

GATT agreement, therefore, there was no need to justify including these exceptions in the agreement.

Contrary to such a stern attitude towards preferences, the GATT broadly permits the formation of free trade areas as an exception to MFN treatment. Why did the GATT let a provision for free trade areas come into the agreement? The first Draft Charter for International Trade Organization (ITO), which was put forward by the US administration in 1946, recognized only CUs as exceptions to the MFN rule.²⁷ It was at the drafting conference that the original concept of a free trade area appeared (GATT Secretariat 1970: 798). In 1947, developing countries proposed the initial concept of a free trade area where "two or more developing countries might be prepared to abolish all trade barriers among themselves, though not wishing to construct a common tariff towards the rest of the world" (Haight 1972: 393). Developing countries might have thought that non-discrimination principles did not always benefit them and a certain degree of preferential treatment would be necessary in order to promote their economic development. Moreover, they needed more flexible schemes than CUs because they regarded forming CUs as a virtually unusable measure to utilize preferential treatment due to their strict conditions.²⁸ The concept of a free trade area received support from many participants in the drafting session and it was successfully incorporated in the draft agreement. The GATT agreement includes this free trade area provision because member countries showed the attitude that they would want to establish certain preferential economic relationships. Some members thought that free trade areas could help rebuild their domestic economies and stimulate world trade in the postwar years without drastic changes to the fundamental trade rules (Baucus 1989: 19; Haight 1972: 394). In addition, it was pointed out that most of the GATT contracting parties had in effect considered that "some degree of discrimination [would] help to promote trade liberalization," and that "not all discrimination [was] bad" (Hudec 1991: 175-76).

During the ITO drafting session, the United States intended that preferences should be restrained and eliminated ultimately. Yet the US administration also intended to apply the GATT agreement as widely as possible in order to enhance its effectiveness. To realize this second objective, it was considered necessary to have the participation of as many countries as possible. However, many countries attending the drafting conference placed more value on "reciprocity" than "non-discrimination." With the purpose of convincing nations to join the GATT, the drafters had to include several measures that would allow nations to pursue their national interests and ease their fears about yielding sovereignty to an international body (Baucus 1989: 5). As a result, the

United States compromised on the issue of including new preferences and accepted the free trade areas as an exception to the unconditional MFN clause.

The flexibility in the MFN obligation of the GATT agreement was quite necessary in order to launch the GATT (Hudec 1991: 175). A free trade area was adopted in Article XXIV so that it could function as a control valve to reconcile the internal conflict between MFN treatment and reciprocity in the fundamental GATT principles.

Examination Mechanisms on RTAs Consistency with the MFN Principle

When the new conception of free trade areas was embraced in the GATT agreement, no debate was contemplated concerning the language of Article XXIV. Therefore, the GATT agreement does not provide an adequate guiding principle to examine whether preferential arrangements can complement the multilateral process of trade liberalization.

The interpretation of the requirements of Article XXIV has long been a disputed issue in the GATT/WTO. While RTAs have been examined many times, no clear-cut assessment as to their consistency with the rules has been conducted. Almost all reports include both the for and against views on consistency since the first examination report on the European Economic Community was adopted in 1957. The breakdown of the examination mechanism on RTAs has resulted from an acute confrontation between two different opinions regarding the RTA role. Some members have evaluated RTAs as a complementary tool for promoting multilateral trade liberalization under the GATT/WTO. Others, in contrast, have expressed concern over the undermining of the multilateral trading system. That is, they worry that RTAs might lead to discriminatory treatment and eventually give rise to trading blocs. Because of the obscurity of the RTA provision, such conflicts of opinion are sometimes embodied in the arguments over Article XXIV.²⁹

The WTO established the Committee on Regional Trade Agreements (CRTA) in 1996 to examine RTAs and present a report. Moreover, the CRTA was to consider the systemic implications of RTAs on the multilateral trading system, as well as the general relationship between RTAs and the trading system (WTO 1996). However, the CRTA has not yet reached any firm conclusions. The WTO itself recognizes that "since 1995 the committee [on RTAs] has failed to complete its assessments of whether individual trade agreements conform with WTO provisions" owing to the controversial nature of the wording of RTA rules.³⁰

A surge of RTAs in recent years has brought about calls for a more effective examination system. WTO members agreed at Doha "to negotiations

aimed at clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements” (WTO 2001a: para. 29).³¹ While an energetic examination mechanism of RTAs is highly required by all member countries, diverse attitudes toward RTAs complicate any debate on detailed regulations. Now, nearly all members are parties to RTAs. At the same time, they are *third parties* to RTAs formed by other countries. As such, they necessarily take contradictory positions in parallel: on one side, they desire to avoid reinforcing RTA rules; on the other side, they feel the need to limit unregulated proliferation of RTAs. Consequently, members seem to hesitate in taking the initiative to strengthen the RTA examination mechanism.

RTAs are inherently reciprocal among agreeing parties and discriminatory against third parties, which contradicts the MFN principle. However, with ambiguous criteria and a malfunctioning examination procedure, RTAs are useful measures to keep reciprocal relationships under the GATT/WTO system.

Reciprocity has functioned as the fundamental principle in negotiating trade issues for a long time. After the establishment of the GATT, member countries have continued to recognize that reciprocity is a significant norm even though it could contradict the GATT principle of non-discrimination. However, “no one knows quite what reciprocity means in concrete terms under the multilateral trade system” (Finlayson and Zacher 1981: 575). The text of the GATT agreement is not particularly helpful since it only alludes briefly to the norm. This ambiguity allows each member to interpret differently the relationship between MFN treatment and reciprocity. Consequently several countries have attempted, probably without full awareness that they were contradicting GATT law, to ensure reciprocal treatment in the GATT/WTO framework.

The road to reciprocity under the GATT/WTO system could take one of two directions: first, it could move in a multilateral direction with conditional MFN treatment, such as the modification of negotiation procedures and the NTB Codes used in the Tokyo Round; or second, it could take a bilateral direction such as CUs and free trade areas that would allow for exceptions to unconditional MFN obligations. These deviations from the unconditional MFN principle could be a return to outright “reciprocal” trade liberalization. As Finlayson and Zacher (1981: 578) state, reciprocity is still a dominant norm in the world trading system.

Incentives for FTAs after the Uruguay Round

From the commencement of the GATT, RTAs have been authorized and utilized as a tool for member countries to hold reciprocal relationships with other states. Under the GATT/WTO system, however, an RTA is not the only way to ensure reciprocity. Trade rounds governed by a package approach and the NTB Codes technique have also been developed to realize reciprocal liberalization. Indeed, in the history of GATT, greater attention has been attached to these methods than to RTAs. Although a free trade area is a device incorporated in the GATT agreement *ab initio*, it has only been during the 1990s that the number of FTAs reported to the GATT/WTO notably increased (see FIGURE 1-1 in Chapter 1). Why have many states become interested in FTAs now? Why have they chosen neither the package approach nor the NTB Codes method? In addition to the specific factors that influence whether states opt for FTAs, broader institutional conditions have also pushed states towards FTAs. Notably two institutional developments brought about by changes to the WTO during and after the Uruguay Round have had this effect. They are: first, the emergence of a deadlock in some areas of negotiations; and second, the strengthening of the “rule of law” under the WTO.

Gridlock at the WTO

While member countries recognize that MTNs still have much significance in promoting freer trade, it is a fact that MTNs have been facing some obstacles. This is attributable mainly to the problem of “too many members with too diverse interests.” The malfunction of multilateral liberalization negotiations is generally regarded as the main cause behind recent FTA proliferation. Since the situation of the WTO expanding its size and scope is similar to that of the United Nations (UN), it is expressed by the term “UNization.”³² A closer examination of the WTO’s UNization would divide the issue into two aspects: UNization as a venue of MTNs, and UNization in terms of the WTO functioning as a diverse international organization.

The UNization of MTN Venues

In January 1948, the GATT started with twenty-three contracting parties who had also participated in the first round of multilateral liberalization negotiations in Geneva the previous year (TABLE 3-1). Till the Dillon Round (1960–61), the number of the participants remained manageable. Moreover, negotiations were actually conducted bilaterally or among a few

TABLE 3-1
THE GATT/WTO ROUNDS

Round No.	Place/Name	Year	Subjects Covered	Participating Members
The First	Geneva	1947	tariffs	23
The Second	Annecy	1949	tariffs	13
The Third	Torquay	1951	tariffs	38
The Fourth	Geneva	1956	tariffs	26
The Fifth	Dillon Round	1960-61	tariffs	26
The Sixth	Kennedy Round	1964-67	tariffs, anti-dumping measures	62
The Seventh	Tokyo Round	1973-79	tariffs, non-tariff measures, "framework" agreements	102
The Eighth	Uruguay Round	1986-94	tariffs, non-tariff measures, services, creation the WTO, etc.	123
The Ninth	Doha Development Agenda	2001-	tariffs, non-tariff measures, etc.	145

Source: WTO (2001).

major trading states on a product-by-product basis, even though they were called *multilateral* negotiations. Conflicts of interest among members were neither so complicated nor so crucial that they could prevent participants from reaching agreements. After the Kennedy Round, however, the number of participants in the GATT trade rounds doubled and finally rose above one hundred at the Tokyo Round.

The UNization of the WTO stemmed not only from its increasing size but also from the broadening range of issues covered. Prior to the Kennedy Round, lowering tariffs on imported goods was the major item on the agenda. After the Kennedy Round, however, the negotiations rapidly expanded their scope to include non-tariff measures. At the Uruguay Round, besides tariff reduction on manufacturing goods, the negotiations encompassed issues concerning market access in services and agricultural goods, anti-dumping, technical trade barriers, intellectual property rights, subsidies and countervailing measures, dispute settlement and many others. Numerous participants and various agendas made negotiations much more complicated and also made conflicts of interest much more acute. As a result, multilateral negotiations under the GATT/WTO tended to be protracted. The Uruguay Round lasted more than seven years.

Recent malfunction in MTNs would be partially ascribable to a characteristic of the GATT: that is, its weak foundation as an implementing body. Jackson (2000: 17–18) describes this institutional weakness, suggesting that “[w]ith scarcely any institutional framework, with no provision for a secretariat, and with legal ties to an organization that failed to materialize, ... in theory at least, GATT was not an ‘institutional organization’ at all—merely an ‘agreement.’” Because of its provisional establishment, the GATT as an institution has been characterized as “joint action by the contracting parties.” Indeed, the principal force for maintaining the progress of trade liberalization and making rules of international trade lay not with the GATT but with the participating parties in MTNs. In this sense, the GATT differed from other Bretton Woods institutions such as the International Monetary Fund (IMF) and the World Bank despite their common origins.³³ From an institutional viewpoint, the GATT simply supported MTNs rather than implemented trade liberalization by itself.³⁴ It is true that the WTO was created as an institution with a legal foundation in order to deal with the flaws of the GATT. However, the WTO inevitably inherits many features from the GATT and so the ascendancy of contracting parties remains. Under the WTO system, the main force for international trade liberalization still comes from “the CONTRACTING PARTIES.”³⁵ Along with decision making by consensus, these kinds of structural problems make it more difficult to reach agreements through multilateral negotiations when the signatory parties to the WTO increase.

A package approach, and now a single undertaking procedure, is another factor making multilateral negotiations more intricate and time-consuming. At the Kennedy Round, where this operational technique was first introduced into the GATT, a package approach was necessary in order to preclude free riding. More than sixty members and the broadened negotiation agendas made free riding more probable than ever before. In addition to ruling out free riding, a package approach has other advantages:

- The size of the package can mean more benefits because participants can seek and secure advantages across a wide range of issues.
- In a package, the ability to trade-off different issues can make agreement easier to reach because somewhere in the package there is something for everyone. This has political as well as economic implications. Concessions (perhaps in one sector) which are necessary but would otherwise be difficult to defend in domestic political terms, can be made more easily in the context of a package because the package also contains politically and economically attractive benefits (in other sectors). As a

result, reform in politically-sensitive sectors of world trade can be more feasible in the context of a global package—reform of agricultural trade was a good example in the Uruguay Round.

- Developing countries and other less powerful participants have a greater chance of influencing the multilateral system in a trade round than in bilateral relationships with major trading nations.

(WTO 2001b: 11)

A single undertaking procedure is an improved measure based on a package approach, and was introduced at the Uruguay Round so as to deal more efficiently with the increasing number of participants and expanding agenda of negotiations. Under this procedure, every item of the negotiation is part of a whole indivisible package and cannot be agreed upon separately. This means “nothing is agreed until everything is agreed.” Even though the method was conceived as the best way to enhance the functionality of trade rounds in expanding the negotiating area, its inherent limitation has come to influence the process of multilateral negotiations. This is because negotiation agendas have broadened much more than the inventors of the procedure could have predicted. It has become harder and harder to adjust complicated interests among all member countries. Consequently, the costs of a single undertaking procedure go beyond its benefits.

Alternative proposals are contrived by necessity if some mechanisms do not operate satisfactorily. Even the WTO, which is the most powerful advocate for MTNs, admits that trade rounds are not the only route to success and suggests other ways such as single-sector talks in basic telecommunications, information technology equipment and financial services (WTO 2001b: 11).³⁶ An RTA is one of the alternatives to multilateral rounds, as can be seen in the following quotation:

A feature of the GATT, and now the WTO, is that a means is provided to overcome some of the problems associated with “foot-draggers.” This is through the provisions for clubs within the club, or more restricted reciprocity in the country dimension: that is for customs unions and free-trade areas. Like-minded countries can go further in more limited reciprocal liberalization if they so desire, provided they go, or say that they intend to go, all the way—that is for free trade among the participants.

(Snape 2001: 144–45)

It seems natural for many member countries to opt for reciprocal liberalization negotiations that are bilateral or regional in order to achieve

more certain and quicker results when they feel frustrated by redundant multilateral negotiations. Moreover, some members regard it as conducive for global trade liberalization “to make progress towards freer trade with smaller groups of countries willing to do so on a reciprocal basis, rather than to wait for the critical mass to emerge” (Davey and Pauwelyn 2000: 15).³⁷

While the package approach “produced trade liberalization on a much broader and more significant scale than had previously been possible in GATT” (Enders 2002: 104), it also made it more difficult to reach agreements among all members. When traditional mechanisms of trade rounds encountered obstacles, members turned quickly towards reciprocal negotiations outside of MTNs (Oye 1992: 29). There are two possible ways to replace a trade round procedure: to limit the participants involved in the negotiations or to limit the size of the agenda for the negotiations. The former leads to the current FTAs surge, while the latter produces single-sector liberalization typified by the Information Technology Agreement. In FIGURE 3-2, MTNs governed by a package approach rate higher on the reciprocity scale than unconditional MFN treatment. However, the diffuse reciprocity of the MTN system no longer meets the requirement for reciprocity held by member countries. The widespread dissatisfaction and disappointment with multilateral negotiations has caused many member countries to alter their trade policy orientation to a more reciprocal approach.

The UNization of the WTO as an International Organization

Recently, the WTO has come to put greater emphasis on assistance for developing countries as its fundamental function.³⁸ Such an attitude can be understood by comparing its original function provided in Article III of the Marrakesh Agreement to its current function listed on its website.³⁹ The WTO currently has six functions: (a) administering WTO trade agreements, (b) providing a forum for trade negotiations, (c) handling trade disputes, (d) monitoring national trade policies, (e) providing technical assistance and training for developing countries, and (f) cooperating with other international organizations. All of these functions, except for “technical assistance and training for developing countries,” are outlined in the Marrakesh Agreement. This means that the WTO has added a new role after its establishment in 1995, and it could be said that the Seattle Ministerial Conference in December 1999 had a considerable effect on the WTO’s concern for developmental issues.⁴⁰

The failure of the Seattle Conference exposed some problems concerning

the WTO's decision making process. The WTO was sharply criticized because its decision making lacked transparency and because it excluded representation from most developing countries.⁴¹ In order to answer such criticism, the WTO is currently working on institutional reforms. Besides overhauling the "green room" process,⁴² the WTO is implementing training programs on human resources so that developing countries can acquire expertise in practicing trade negotiations, which is regarded as the first step in allowing all members, especially developing countries, to participate in decision making in a more active and equitable way.

The WTO is paying much attention to assisting developing countries mainly because it recognizes the necessity and significance of performing such a role. However, it seems that the WTO still needs to produce more results as an international organization. Traditionally, the primary objective of the GATT/WTO has been "the substantial reduction of tariffs and other barriers to trade and . . . the elimination of discriminatory treatment in international commerce" (GATT Preamble). With this statement in mind, the GATT/WTO has not only successfully reduced tariffs but has also created rules regarding non-tariff measures since the Tokyo Round. Furthermore, the WTO is trying to construct trading rules on new issues such as electronic commerce. At the same time, it is attempting to facilitate a more efficient trade environment by implementing standardization and harmonization. However, the impasse over MTNs affects the WTO's primary role of administering a forum for trade negotiations. In terms of tariff elimination, it is difficult to reach agreement on remaining issues such as agricultural products. With regard to rule-making agendas, the interests of member countries on issues at the present trade round, for example anti-dumping and intellectual property rights, are so different that there seems hardly any room for deal-making. Multilateral agreements have *already* been concluded in areas for which a consensus was possible. The WTO is currently consolidating its position as a dispute settlement body in the area of trade conflicts. However, in general, arguments regarding the necessity of international organizations continue to exist.⁴³ If an organization is regarded as having lost its usefulness, a strong possibility exists that it may be merged or disbanded. Every international organization, even the WTO, cannot be immune from this reality. In order to survive as an international organization, the WTO will need to create new and worthwhile functions. At present, in addition to handling trade disputes and monitoring national trade policies, the assistance of developing countries is becoming a big issue at the WTO.

Owing to this need to take on additional functions, and also because of the expansion of negotiation agendas, the WTO needs to interact more

frequently with other international organizations such as the United Nations Conference on Trade and Development (UNCTAD), the International Labor Organization, the World Bank and the IMF. In fact, the WTO recently held a conference on development issues with the World Bank and began a project on administrative capacity development with UNCTAD.⁴⁴ These WTO activities are beneficial for government officials in developing countries because they help them acquire technical skills in trade negotiations. On the other hand, there is a concern that, by increasing such assistance, the WTO is shifting its main function. What is expected by member countries of the WTO varies from day to day. Presently, members who want to accelerate liberalization negotiations are inclined to look for alternate forums to realize their concerns rather than expect the WTO to perform such a function. In this context, the functional transformation of the WTO may lead to the proliferation of bilateral or regional FTA negotiations.

Strengthening of the "Rule of Law"

The GATT was not an institution established by a treaty-based instrument like the UN or IMF but merely by a general agreement, even though it has had an actual secretariat and has functioned as a *de facto* international institution. The lack of an institutional legal basis has hindered its ability to function as an efficient implementing body. This became more problematic "as the GATT grew in scope and detail to cope with a fascinating set of concrete problems of international economic relations" (Jackson 1998: 13). At the Uruguay Round, many substantive trade rules were agreed upon. Some contracting parties called attention to the idea that the GATT should grow stronger organizationally in order to ensure the implementation of agreements in the Uruguay Round and promote liberalization more effectively. After the intensive arguments of the Uruguay Round, the GATT was reformed into a new institution in 1995. The establishment of the WTO brought about the enhancement and expansion of the "rule of law" in international trade relations. The most notable improvement was the strengthening of the dispute settlement system.

Owing to this structural change, member countries should abide by the WTO rules more strictly than in the GATT era, which may make them hesitate to utilize the code approach. Historically, some member countries made the most of the code approach to ensure reciprocal treatment and quick results with like-minded countries even if such actions were occasionally inconsistent with the unconditional MFN principle. Indeed, the NTB Codes in the Tokyo Round entered into effect after 1968 when the

GATT Secretariat formally applied a legal brake on the code approach. The Codes continued to exist because the GATT had neither an effective mechanism nor precise provisions in order to appraise whether they were legally compatible with the GATT agreement. However, the enhancement of the “rule of law” was brought forth by the launch of the WTO, and, consequently, dispute settlement procedures became binding and mandatory. At present, there seems to be fairly strong pressure to prohibit discriminatory treatment by means of the code approach under the WTO system.

Likewise, the rules-based multilateral trading system under the WTO covers subjects concerning RTAs. Paragraph twelve of the “Understanding on the Interpretation of Article XXIV of the GATT 1994,” which was one result of the Uruguay Round, provides that WTO dispute settlement bodies consisting of a panel and an Appellate Body have jurisdiction to examine “any matters arising from the application of those provisions of Article XXIV.” In general, this rule-oriented attitude of the WTO seems to prevent member countries from utilizing RTAs because an RTA deemed inconsistent with WTO principles can be brought before the WTO under its dispute settlement procedure. In fact, however, the number of RTAs, including RTAs being negotiated or being considered for negotiation, has been increasing since 1995. The advantages of the rule of law are countered by the deadlock in examining RTAs. Both the panel and the CRTA, which are the bodies available to examine whether an RTA is consistent with WTO rules, cannot perfectly play such a role because they have no clarified provisions upon which judgments can be made. Furthermore, WTO dispute settlement bodies do not necessarily see themselves as a relevant place to evaluate RTAs.

[T]his [paragraph twelve of Understanding on Article XXIV] meant that WTO adjudicating bodies could examine the WTO compatibility of one or several measures “arising from” Article XXIV types of agreement. The panel was, however, of the view that the CRTA appeared to be, generally, in a better position to assess the overall GATT/WTO compatibility of a customs union, since it involves a broad multilateral assessment of any such custom union, i.e. a matter that concerns the WTO membership as a whole.

(Marceau and Reiman 2001: 312–13)

However, the CRTA also cannot work as an assessment mechanism due to the lack of specific RTA rules. The CRTA cannot clarify rules because of the prevailing opinion that it is not committees but member countries who set the rules.⁴⁵

Under the current circumstances—that is, where the governance of the law is enhanced—member countries are prone to avoid taking a code approach which may fall into a “gray area.” Instead, they opt for RTAs on the ground that they are formally permitted as an exception to MFN obligations in Article XXIV.⁴⁶

Conclusion

An historical examination of MFN treatment suggests that it was born of necessity—the need to avoid troublesome and repetitive procedures by applying the same conditions to all trade partners. Early MFN clauses functioned as instruments to generalize concessions, while modern clauses before World War II worked as a means to protect national interests. A new form of MFN treatment—the conditional MFN clause—developed when MFN practices were united with the concept of reciprocity. After the incorporation of reciprocity into MFN treatment, conditional and unconditional clauses alternated as the most widely used MFN clause. In the GATT-based, multilateral trade system, non-discrimination was adopted as a fundamental principle. Unconditional MFN clauses were considered to be an effective measure for applying this principle to actual trade practices. In this sense, the unconditional MFN clause provided in the GATT agreement differs from the unconditional clauses that were employed by the United States in its bilateral trade agreements in the prewar period.

However, in putting an unconditional MFN clause into operation under the GATT, several difficulties emerged, difficulties that resulted, in part, from the controversial nature of the two GATT principles, non-discrimination and reciprocity. At the early GATT rounds, multilateral trade liberalization was pursued in two phases: first, stepping forward liberalization by bilateral negotiations; and second, distributing the benefits of each bilateral and reciprocal negotiation. An unconditional MFN clause from the GATT/WTO can operate better in the latter stage than in the former. It is widely believed that reciprocity is at the core of trade liberalization negotiations. On the other hand, the extension of concessions can be characterized as non-reciprocal because the outcomes of negotiations should be automatically multilateralized through an unconditional MFN clause. Some major trading countries became reluctant to grant concessions to all GATT members without any compensation. In order to diminish concerns about free riding, the operational procedure for trade rounds was modified. Under a new liberalization approach, members negotiate multilaterally on various issues at

the beginning and then further liberalization at one stretch by accepting packaged agreements.

Multilateral trade liberalization based on non-discrimination has paralleled the exemption of other practices from MFN obligations. While all members respect multilateral liberalization based on non-discrimination, it is a fact that some member countries have looked for reciprocal relationships with other members outside multilateral negotiations. Under the present GATT/WTO system, it is problematic that unconditional MFN treatment always assures reciprocal liberalization, even though reciprocity is approved as a basic principle of the GATT/WTO. As long as unconditional MFN treatment under the GATT/WTO system is non-reciprocal, deviations from MFN treatment (such as NTB Codes) or exceptions to MFN treatment (such as FTAs) are necessarily given considerable attention. This is the fundamental institutional motive for FTAs.

In addition, the lessening of the WTO function in terms of multilateral liberalization negotiations may have accelerated the trend for FTAs after the Uruguay Round. UNization at the WTO, not only as a forum for multilateral negotiations but also as an international organization, puts the WTO in a gridlock, which causes member countries to feel reluctant to join multilateral liberalization negotiations. Currently, the disadvantages of a package approach exceed its advantages, for example, the exclusion of free riding and the enabling of trade-offs among different issues. Under such a situation, member countries lessen expectations of diffuse reciprocity, which has been exercised effectively in trade rounds by means of single undertaking procedures, to guarantee reciprocal relations. Then, they call on more reliable measures to obtain straightforward reciprocal relations without delay, that is, FTAs based on specific reciprocity. Moreover, the strengthening of the "rule of law" under the WTO framework, as a result of institutional reform in 1995, adjusts the way in which member countries implement reciprocal negotiations. Historically, states sometimes made use of "gray zone" measures that were inconsistent with the WTO regulations. By contrast, they are currently inclined to form FTAs because FTAs are authorized as an exception to unconditional MFN obligations. Due to the malfunctioning of examination mechanisms on RTAs, member countries seem to have discretionary power to some extent concerning what kind of FTAs they can form.

The drafting process for the provision of free trade areas shows that they were incorporated into the GATT agreement in order to placate some participants who emphasized reciprocity over non-discrimination. Free trade areas, which were nothing more than an "exception" to the MFN principle at

the time, have come to play a significant role in today's world trade system. However, FTAs inevitably discriminate against third parties. Although the number of FTAs may be increasing, that does not justify their intrinsically discriminatory nature. The principle of non-discrimination is the very essence of the WTO multilateral trade system, and RTAs should be compatible with the WTO rules so that the free trade system led by the WTO process can be sustained. A robust assessment mechanism of individual RTAs in terms of their compliance with WTO rules could ensure that RTAs do not emerge as a stumbling block in the way of freer international trade but emerge instead as a building block for multilateral trade liberalization.

Notes

- 1 Though the GATT was not an institution established under a treaty-based instrument like the UN, but merely a general agreement, it has had an actual secretariat and has functioned as a *de facto* international institution. In this chapter, therefore, the term "GATT" will mean institution and "GATT agreement" will mean an international agreement.
- 2 These two terms are applied by Keohane (1986). According to Robert Freeman Smith, diffuse reciprocity and specific reciprocity are respectively open reciprocity and restrictive reciprocity (Ishikawa 1985: 10–11). Cline (1982) calls them passive reciprocity and aggressive reciprocity.
- 3 Reciprocity is often regarded as synonymous with "mutual relationship." Yet they are different. First, in a reciprocal relationship, a voluntary action belongs only to the giving side because a contingent action is obligatory in return. In contrast, a "mutual" relationship occurs when both participants give to each other of their own free will. Second, reciprocity includes balance and symmetry in the sense of a bilateral relationship where one gives and the other returns. By comparison, a mutual relationship does not necessarily require such a balance between participants (Kuwahara 1975: 416).
- 4 These two different actions are clearly distinguished in the GATT vocabulary: an original tariff reduction is a "concession," while a reciprocal reduction is "compensation" (Dam 1970: 65). Moreover, the contingent actions are inevitably taken in such a way that "good is returned for good, and bad for bad" (Keohane 1986: 8). This produces a "tit for tat" policy, which could lead to a retaliatory relationship if the negative aspect of reciprocity is used excessively.
- 5 The side that receives benefits through a contingent action by the other side is strongly expected to respond to the antecedent action in time. As Keohane (1986: 20) notes, "a pattern of diffuse reciprocity can be maintained only by a widespread sense of obligation."
- 6 According to Hornbeck (1910: 11), the first appearance of an MFN clause in written treaties occurred on November 8, 1226, when Emperor Frederick II

- conceded to the city of Marseilles the privileges previously granted to the citizens of Pisa and Genoa.
- 7 According to Murase (1974: 60–61), the balance-of-power system in the late seventeenth century supported the mechanism of MFN treatment in the sense that the relations between states operated on a system involving equal treatment.
 - 8 However, the second party (in this case, France) may have had the right to demand the favor on allowing the same concessions (Hornbeck 1910: 25).
 - 9 Concerning the idea of a conditional MFN clause, MFN treatment at the time of concluding an agreement would be secured, while future discrimination would not necessarily be denied. However, the United States insisted that a conditional MFN clause would not be discriminatory on the basis that, whenever the United States exchanged MFN treatment, it inserted a conditional MFN clause and did not conclude any exclusive arrangements with specific states. In this sense, the United States treated every state equally. Hornbeck (1910: 25), in describing this US attitude, suggests that the opportunity was given to each country to purchase for itself such favors as might be granted to others for compensation.
 - 10 In the latter half of the eighteenth century, when the United States won independence, the European Great Powers had ordered international political and economic relations on the models of imperialism and mercantilism. The United Kingdom and the other European powers had set up preferential trade arrangements with their own colonies, and they discriminated against other countries by imposing high tariffs. Because the United States was a latecomer to world trade and had no colonies, it could only insist upon reciprocal treatment with a conditional MFN clause.
 - 11 According to Winham (1992: 18), this treaty demonstrated that trade agreements could be an effective means of trade liberalization.
 - 12 It has been pointed out, however, that those countries which were most consistently protectionist, such as Russia, favored conditional clauses (Hornbeck 1910: 56).
 - 13 In the 1860s, the major European powers concluded commercial treaties with unconditional MFN clauses. For example, Italy concluded twenty-four treaties, the German Customs Union had eighteen, Austria-Hungary had fourteen, France had nineteen, and Belgium had twelve (Murase 1974: 84). Despite such circumstances, the United States did maintain a conditional MFN clause (US Tariff Commission 1919: 19).
 - 14 According to David A. Wells, quoted in Laughlin and Willis (1903: 6, 16), the commerce of Austria, Belgium, France, Holland, Italy and the United Kingdom grew by more than 100 per cent between 1860 and 1873, while the trade of these countries with states that had not entered into reciprocal treaties increased only by about 60 per cent.
 - 15 The contracting partners to the bilateral agreements were, for example: Argentina, Brazil, the Belgo-Luxemburg Economic Union, Canada, Colombia, Costa Rica, Cuba, Ecuador, El Salvador, Finland, France, Great Britain and Northern Ireland, Guatemala, Haiti, Honduras, Iceland, Mexico, Netherlands, Nicaragua, Peru, Sweden, Switzerland, Turkey, Uruguay and Venezuela.
 - 16 The United States promoted protectionism with the Smoot-Hawley Tariff of 1930, which raised US tariff rates steeply. This triggered a series of discriminatory bloc making. In 1931, for instance, the German-Austrian Customs Union was established, and preferential tariff treatment was applied among members of the

- British Commonwealth after the Ottawa Conference held in 1932. The RTAA was legislated as the amendment to the Smoot-Hawley Tariff of 1930.
- 17 It is significant that the RTAA did not depend on specific reciprocity, even though it aimed at reducing tariffs and other trade barriers by bilateral negotiations. Instead, the RTAA relied on diffuse reciprocity. The United States made this change partly because the conditional MFN policy brought about never-ending negotiations and bargaining (Tasca 1938; Dam 1970).
 - 18 Article III deals with the regulation of foreign products and indicates that, once they are imported and tariffs are paid, they should be treated on equal terms with domestic products in respect to taxes and other requirements. In other words, Article III enforces the National Treatment rule.
 - 19 The 1942 agreement between the United States and Mexico is generally described as the model for the initial draft of the GATT agreement that was submitted by the United States in 1946 (Hudec 1987: 7).
 - 20 Oye (1992: 27, 96–102) argues that liberalizing bilateral agreements negotiated under the RTAA was discriminatory.
 - 21 At the Bretton Woods Conference, four concepts of liberalization, reciprocity, multilateralism and equal treatment were advocated as its aspirations (Diebold 1996: 153). Also, the GATT's preamble describes its primary purpose as the promotion of "reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce."
 - 22 Over the fifty years of its history, the GATT/WTO had nine trade rounds. The first five were called "multilateral *tariff* negotiations," while the subsequent rounds were known as "multilateral *trade* negotiations." This change in the name reflects the GATT's development. The GATT gradually evolved through the series of rounds in terms of increasing its size, broadening the scope of issues covered and improving the negotiation process. However, at the Kennedy Round, the characteristics and function of the rounds underwent dramatic change. Prior to the Kennedy Round, the reduction of tariffs on imports was the major item on the agenda. However, after the Kennedy Round, the scope of negotiations rapidly expanded to include non-tariff measures.
 - 23 At the Tokyo Round, eight Codes on NTBs were adopted. Six of them were eventually amended at the Uruguay Round and turned into multilateral commitments accepted by all WTO members. However, two Codes on government procurement and civil aircraft remain "plurilateral" agreements, that is, they apply to only countries that are signatories (WTO 2001b: 10).
 - 24 In addition, the United States managed to achieve recognition of a "graduation" scheme by which developing countries would be expected "to participate more fully in the framework of rights and obligations under the General Agreement." Accordingly, the United States required what it thought appropriate reciprocity from selected developing countries (Hudec 1987: 86). At the same time, the United States made use of bilateral negotiations outside the context of the GATT.
 - 25 In addition to preferences, several categories are allowed as exceptions to MFN treatment under the GATT agreement. The GATT Secretariat enumerated twelve cases of exceptions to the rule of non-discrimination which are provided for in the GATT agreement itself (GATT Secretariat 1970: 795–99). These include, for example, retaliation against a discriminatory application of quantitative restrictions

- and response to an emergency action affecting imports.
- 26 Article I simply allows preferential trading arrangements *in force* at the time of GATT's establishment to last as exceptions to the MFN principle with the conditions listed in the Annex. Almost all are imperial preferences or preferences between neighboring states.
 - 27 In March 1948, the ITO Charter was adopted at the United Nations Conference on Trade and Employment in Havana. Since only two countries ratified the Charter, the plan to establish the ITO lost momentum. However, in order to enforce the results of the trade round, parts of the ITO Charter were selected to form the core of the GATT agreement.
 - 28 In order that a preferential arrangement is authorized as a CU, it should meet at least three requirements: the elimination of duties among parties, the setup of common external tariffs, and the harmonization of foreign trade regulations.
 - 29 At the Uruguay Round, member countries discussed clarifying the criteria and procedures for the assessment of RTAs and, as a result, adopted the Understanding on the Implementation of Article XXIV of the GATT 1994. There were some improvements such as the inclusion of a definition of a "reasonable length of time" as generally within ten years. However, consensus could not be reached on many issues. For example, the meaning and calculation of "substantially all the trade" remain unclear.
 - 30 See an unofficial explanation of the Doha Declaration at the WTO website. (http://www.wto.org/english/tratop_e/dda_e/dohaexplained_e.htm). Last accessed on March 28, 2003.
 - 31 Negotiations, which are aimed to end by January 1, 2005, are taking place within the Negotiating Group on Rules, as an integral part of the single undertaking. However, the issue of RTAs seems not to be a central part of the Doha Development Agenda. Interview with Japanese representatives to the WTO and an official of the WTO Secretariat, September 2002.
 - 32 This is a translation from the Japanese term *Kokurenka*, which is frequently used to describe the current WTO situation.
 - 33 The IMF and the World Bank were established as implementing bodies and their decision making mechanisms are efficient enough to carry out their mandatory tasks.
 - 34 Interview with officials of the WTO Secretariat, September 2002.
 - 35 In Article XXV, the GATT agreement provides that "[w]herever reference is made in this Agreement to the contracting parties acting jointly they are designated as the CONTRACTING PARTIES" (capitals in original).
 - 36 However, Aggarwal and Ravenhill (2001) point out that a sector-by-sector approach could undermine the role of comprehensive MTNs.
 - 37 Many support such opinions especially in Singapore, which is a leading promoter of FTAs. Interview with a Singaporean scholar, August 6, 2001.
 - 38 Interview with a WTO official, September 2002.
 - 39 See the fact file of the WTO at its website. (http://www.wto.org/english/thewto_e/thewto_e.htm). Last accessed on March 28, 2003.
 - 40 Interview with a WTO official and officials of the Organisation for Economic Co-operation and Development, September 2002. They pointed out that it was after the Seattle Conference that the WTO realized it was necessary to pay more attention to developmental issues.

- 41 For details regarding problems in decision making processes, see Schott and Watal (2000: 283–92).
- 42 A system of Green Room meetings involves informal consultations of around thirty countries most interested in the particular issue under discussion. Informal consultations are considered to “play a vital role in bringing a vastly diverse membership round to an agreement” and, even though “they are necessary for making formal decisions, they never appear in organization charts” (WTO 2001). Due to its lack of transparency and undemocratic features, the Green Room system was the most harshly criticized at the Seattle Conference.
- 43 For example, there is an opinion that has demanded a scrap-and-build plan for UN specialized agencies.
- 44 An UNCTAD official testified that consultations with WTO officials take longer than before. Interview with an UNCTAD official, September 2002.
- 45 Interview with officials of the WTO Secretariat, September 2002.
- 46 The Appellate Body obviously states that the RTAs provision can exempt member countries from MFN obligations: “non-discrimination obligations apply to all imports of like products, except when these obligations are specifically waived or are otherwise not applicable as a result of the operation of specific provisions of the GATT 1994, such as Article XXIV” (WTO 1997: para. 191).

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