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LEAGUE OF NATIONS

**ECONOMIC COMMITTEE**

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**EQUALITY OF TREATMENT IN THE PRESENT STATE  
OF INTERNATIONAL COMMERCIAL RELATIONS**

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**THE MOST-FAVOURLED-NATION CLAUSE**

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**EXTRACT FROM THE REPORT OF THE ECONOMIC COMMITTEE  
TO THE COUNCIL ON THE WORK OF ITS FORTY-FOURTH SESSION.**

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The Committee has also devoted long consideration to the question of equality of treatment in international economic relations which it is the object of the most-favoured-nation clause included in commercial treaties to ensure. It has in particular directed attention to the influence exercised by existing hindrances to the working of the economic mechanism on the rule of equality of treatment and also to the divergencies in the interpretation of the clause which have come to light, as well as to the disfavour which the clause has incurred in certain quarters.

The Committee submits to the Council the result and conclusions of its study in document C.379.M.250.1936.II.B, entitled : " Equality of Treatment in the Present State of International Commercial Relations : The Most-favoured-nation Clause ".

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## EQUALITY OF TREATMENT IN THE PRESENT STATE OF INTERNATIONAL COMMERCIAL RELATIONS.

### THE MOST-FAVOURLED-NATION CLAUSE.

#### L — Essentials of the Problem.

So much has been written, and written with such authority, on the most-favoured-nation clause and the system of equal treatment which it is intended to ensure, that the subject might well be regarded as exhausted.<sup>1</sup>

The Economic Committee is anxious, nevertheless, to submit the following observations to the Council because the clause has recently given rise to keen controversy in a number of countries. That controversy has arisen from the fact that the depression, by its adverse effects on the machinery of international trade, has brought about modifications in the conditions which are indispensable for the effective operation of the clause.

Hence has arisen a series of misunderstandings which it is highly desirable to clear up and dispel once and for all.

It should first be emphasised, however, that the Economic Committee does not intend to deal as it has done in the past<sup>2</sup> with the form, the field of application and the interpretation of the most-favoured-nation clause as a contractual stipulation.

It proposes, on this occasion, to consider the problem from a more general and detached point of view, and to describe how the depression and the conflicting policies by which the various States have endeavoured to counteract it have directly or indirectly compromised the guarantee of equal treatment which the clause was sufficient to afford in normal times.

The Committee, however, has confined its survey to the problem as it affects trade, leaving on one side other matters such as the treatment of foreigners and foreign undertakings, navigation, etc., which, in numerous commercial treaties, are also made subject to the regime established by the clause.

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1. Since the time when means of communication became so widely developed sufficiently as to make it possible to speak of world trade in the present sense of the term, no country has been willing or able to admit the application to its exports in the country of destination of higher or more burdensome Customs duties or other import charges than those applicable on importation to the goods of other countries.

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<sup>1</sup> Some of the most recent studies on the subject are noted in an annex. The Committee desires, however, to draw special attention to the report by Professor Charles Rist, assisted by Mr. J. H. Herberts, for the Joint Committee of the Carnegie Endowment and the International Chamber of Commerce, entitled: "Past and Future of the Most-favoured-nation Clause". The main ideas of this study are also to be found in a French official document: "Rapport adressé au Ministre du Commerce et de l'Industrie au nom du Comité d'étude pour l'adaptation du régime douanier" (published as Annex "Régime douanier (447)" to the *Journal Officiel de la République française*, of June 4th, 1936).

<sup>2</sup> See "Recommendations of the Economic Committee on Tariff Policy and the Most-favoured-nation Clause" (document E.805, Geneva, 1933).

To guard against this danger, two countries concluding a commercial treaty have been in the habit of undertaking mutually to apply to each other's goods *the most favourable rates of duty*—that is to say, the lowest duties applied by either, whether at the time of concluding the treaty *or in the future*, to similar goods coming from any other country. Hence the expression, "most-favoured-nation treatment".

While this system was in use between nearly all countries engaged in regular foreign trade—that is to say, more particularly during the period from 1860 to the world war—it followed that the same goods, whatever the country of origin, were all subject in a particular country of destination to the same duties, so that ultimately there was something in the nature of a collective contract based on *equality of treatment* guaranteeing to the countries concerned what they regarded as the indispensable minimum of commercial security.

The system may be said, therefore, to have originated as a measure of precaution against possible injury, or if the expression is preferred, as an act of self-defence by an exporting country against the risk of finding its exports treated less favourably than those of others.

*The clause is not, and does not purport to be, anything more than the legal embodiment of this precaution.* From the fact, however, of its widespread use, it had the effect of making the system of equality of treatment general.

2. Moreover, the clause was developed to its full extent in the course of a period (1860 to 1914) in which Customs duties were for all practical purposes the only barrier which could have any effect on the movements of international trade—a relative barrier, it is true, since they applied only to the prices, and not directly to the volume, of imported goods. There is nothing surprising therefore in the fact that it is difficult to cope successfully by means of the clause with dangers arising as a result of *other obstacles*, such as quotas and foreign-exchange control, with which it was never meant to deal.

The reason why, during this period of expansion in world trade, the commercial world was able to accept the clause as affording an adequate safeguard was the fact that the whole structure of international trade was founded on *three fundamental conditions* which were regarded as natural and permanent :

- (1) Freedom to trade in goods without quantitative limitation—although subject to Customs duties ;
- (2) Unhampered convertibility of currencies in the international market ;
- (3) Currency stability in such degree as to preclude sudden disturbances of the competitive basis and to allow at any rate approximate estimates of profit and loss to be made.

During the post-war period, the general collapse in prices and the check to the expansionist tendency of trade deprived world economy of two factors essential to its development. At the same time, their changes led to the adoption of fresh measures of restriction as a result of which, in some instances, the clause ceased to operate or could not operate effectively. The development just described is strikingly reflected in the parallelism which exists between the use of the clause and the growth of foreign trade. Thus, between 1860 and 1914, a period of great expansion in world trade, the use of the clause became more and more prevalent, so that it became, as it were, the "golden rule" of commercial policy. Similarly, during the recovery which followed the post-war depression, the clause regained ground and appeared in the principal commercial agreements of that time. On the other hand, with the rapid decline in trade experienced after 1929, the clause lost ground until it almost ceased to operate in the commercial relations of a number of countries.

Thus, when world trade is following an upward course, it will be found that the system of equality of treatment is established or re-established all along the line, whatever the theories in favour at the moment. When world trade declines, on the contrary, the clause suffers with it.

So long as the world market continues to represent a progressively increasing quantity, or so long as it is not under the influence of quantitative restrictions hindering its development,

the normal expansion of a nation's exports demands no more than ability to compete in the market on equal terms. Each country in such circumstances will claim most-favoured-nation treatment, and, in order to obtain it, will accord it to others.

But when the world market represents a progressively contracting total, two changes occur.

(1) The protection of the home market becomes a much more engrossing consideration than the development of exports ;

(2) In so far as exports are still essential, it is no longer sufficient to be assured of equality of treatment : it is necessary to secure as substantial a share as possible of this diminishing remnant of trade at the price of special concessions. Control of the trade-balance, compensation and clearing agreements and the like neutralise the practical benefit of the most-favoured-nation clause even if the legal right remains and although the clause continues to operate in regard to Customs duties.

But a disaster such as a catastrophic collapse in the volume of trade never comes alone. A decline in the volume of trade is inevitably accompanied by a sudden fall in values—*i.e.*, in prices—by which the whole balance of payments is placed in jeopardy.

This process has resulted in certain countries in devaluation and instability, in terms of gold, of currencies which had abandoned their former gold parities. In others, the function of currency as an international medium of payment has been limited or entirely suppressed by the establishment of foreign-exchange control followed by clearing and compensation agreements.

In others, again, freedom of trade was restricted by the introduction of different systems of import quotas.

These three functional disturbances of the international organism had no sooner come into operation in different parts of the world than they began to make their influence felt from one country to another, and eventually, by reciprocal interaction, accentuated the disorder originally caused by the disastrous fall of prices to such a point that the most-favoured-nation clause was no longer able effectively to perform its functions ; at any rate, as between countries with quota systems or exchange controls. It was no longer possible for the clause alone to assure the countries concerned an effective equality of treatment, since this equality was now compromised by a number of factors other than Customs duties, factors which were often more powerful in operation than Customs duties could be.

3. This is the present position of a large number of countries, including the majority of European countries ; they are either the authors or the victims of the anomalous systems of regulation referred to, and in many cases they suffer in both respects. It is not surprising, therefore, that public opinion should be at a loss, nor that a certain confusion in regard to cause and effect should prevail in many minds.

*The most-favoured-nation clause is made responsible for injuries which are due in reality to the breakdown of the machinery of trade, the regular operation of which cannot be interrupted without depriving the clause of a great part of its effectiveness.*

That this is the fact is shown by the present situation. Monetary devaluation has been mentioned above as one of the factors leading to the weakening of the clause in international relations. But this must be understood in the sense that the effect of devaluation, particularly at the outset, was to divert an unusually large quantity of goods to countries whose currencies had not been devalued. These goods were cheap but, at the same time, the countries to which they were sent found it increasingly difficult to export. This led to the adoption of measures of defence, culminating in a widespread application of quotas and foreign-exchange control and so to a situation necessarily in conflict with the operation of the safeguards embodied in the most-favoured-nation clause. These results did not follow in most countries in which monetary devaluation occurred, since devaluation is not in itself an obstacle to the operation of the clause—if there is no discrimination in the Customs duties—provided there is no simultaneous resort to quotas or foreign-exchange control.

Thus, it may be said, broadly speaking, that there are now two distinct groups of countries so far as equality of treatment is in question :

(a) *Countries whose trade is unrestricted, often triangular, and able to expand.* — These are countries which have devalued their currencies, but in general have not applied quotas and have not imposed foreign-exchange control.

This group is of the highest importance, since it includes the sterling group of countries and the United States, representing between them some half the trade of the world.

(b) *Countries whose trade is restricted or controlled and confined in its development within bilateral compensation agreements, and evinces a static or restrictive tendency.* — These are countries which, having currencies based on gold reserves or a nominal monetary stability, yet impose strict limitations on foreign trade by establishing quotas for goods or foreign exchange or both. This group accounts for more than one-third of the world's trade, and includes the majority of European countries.

In the countries of the first group, Customs duties retain their functions in their entirety, and the most-favoured-nation clause with its provision for equality of treatment has lost none of its value.

To say, therefore, as is often done, that the clause *has to-day ceased to operate* is a generalisation for which the facts afford no justification.

On the other hand the assertion is in great measure true in the case of the countries of the second group. Quotas and foreign-exchange control seem by their nature to be inconsistent with the spirit of the most-favoured-nation clause and its satisfactory operation, as will be made clear in what follows.

4. The division of countries into the groups mentioned above shows that the principle of equality of treatment continues to govern a great part of international trade, and leads to the conclusion that, if the breakdown of the machinery of trade to which reference has been made were to spread throughout the world, equality of treatment would virtually cease to exist or would require the adoption of new and hitherto unknown methods to secure its preservation.

If, on the other hand, the conditions which the clause was intended to meet were once to be re-established, or if at any rate the material obstacles in the way of the circulation of goods and money were to disappear, it would soon be apparent that no country would be prepared to forgo the safeguards which the system of equality of treatment embodied in the clause can alone ensure. To do so would be difficult—if not impossible—for any country, for the reason that while exporters may be prepared to tolerate tariffs, and even high tariffs, so long as they share the burden with others, they will never be prepared in the long run to submit to measures which they consider to be directed specifically against themselves. Any Government leaving them defenceless against discrimination of this kind would soon be the object of criticism against which it could not hold out.

5. *But, if a country desires to obtain the benefit of equality of treatment for its exporters, it can only do so by giving equality of treatment to other countries.* It may therefore be anticipated that, as the impediments referred to are mitigated and disappear, the principle of which the most-favoured-nation clause is the expression will automatically be re-established. The above prediction is more likely to come true because it is based not on purely theoretical economic reasoning, which may be subject to error, but on the certainty of the response to the dictates of self-preservation.<sup>1</sup>

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<sup>1</sup> The above anticipation is supported by the experience of many generations. The following passage from the above-mentioned report of Professor Rist contains interesting historical examples of this development.

“Despite unceasing criticism of the clause,” Professor Rist writes, “there can be no doubt that its domain has constantly been extended in the course of the past years. The very attempts made to eliminate it, during the past fifteen years, have but served to demonstrate its vitality.

“As will be remembered, the development of the most-favoured-nation clause dates from the seventeenth and eighteenth centuries, culminating in the nineteenth century with the Cobden-Chevalier

The position would not differ greatly in the case of a country which has a managed economy, much bureaucratic control of enterprise, and which is dominated by "totalitarian" conceptions. Indeed, such a country would be even less disposed than others, owing to the strength of its habitual reactions, to tolerate discrimination against its nationals in foreign markets. It would press for the safeguards which the clause affords, and would be forced itself to give what it sought to obtain.

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treaties of 1860, by which it was made the common commercial law of the great European powers. It was inserted in the Treaty of Frankfort, which terminated the war of 1870-71, not, as often believed, at the request of Germany, but at the urgent request of the French negotiator—Pouyer-Quartier. This insertion marked, as it were, the definite victory of the clause, in that it confirmed the triumph, over the prejudices and bitterness born of the war, of the desire of two recent enemies to restore complete commercial equality.

"Since that date, various endeavours have been made to elude its consequences; each of them has, however, resulted in a further triumph of the clause. Of these attempts, three are particularly significant—namely, two belonging to the Customs history of France, the third to that of the United States.

"France reverted to protectionism in 1892, after thirty years of liberal trade policy. Among the objections called forth by the liberal policy initiated in 1860, one of the most serious concerned the increased competition with which the French producer was faced on the application of the clause to each new commercial treaty. The French Parliament sought a remedy in the form of the so-called "Double Tariff" system (maximum and minimum), the minimum tariff constituting a limit below which French negotiators were not allowed to descend. The law further provided for the application of intermediate tariffs, lying between the maxima and minima tariffs, the idea of the legislator being that these intermediate tariffs should vary according to the different treaties. What actually happened? The negotiators were from the outset obliged to grant certain countries the minimum tariff, together with the most-favoured-nation clause, refusal of which by France would in return have deprived the latter of equality of duty in the country with which it concluded the treaty. The natural consequence was that, in a relatively short time, the majority of States finally obtained the benefit of the minimum tariff, and the intermediate tariff envisaged in the Customs Law of 1892 remained a dead letter. What is more, France was in certain cases obliged to descend below the minimum tariff in virtue of the so-called "consolidated duties" and all countries to which the most-favoured-nation clause had been conceded likewise claimed the benefit of such consolidation.

"The second attempt made by France to elude the consequences of the most-favoured-nation clause took place immediately after the war. At that moment, France had denounced all commercial treaties. She was accordingly faced with the necessity of negotiating new agreements with all countries. A law dated July 29th, 1919, reinstated the notion of intermediate tariffs, already contained in the tariff issued in 1892. The question was to place the French trade relations with the different countries on a footing which varied according to their economic position. The same law re-embodied a formula borrowed from the American system and contained in the 1892 law which provided that concessions as regards the maximum tariff could only be granted in exchange for 'correlative advantages'. This was the basis on which the first French negotiations were conducted. But if we examine the formulæ applied to the various agreements actually concluded, we find that they tend, directly or indirectly, towards the re-establishment of the most-favoured-nation clause, and that, in the case of the 1927 agreements defining the commercial relations between France and Germany, the treatment of the most-favoured-nation clause 'is formally applied to Germany under Article VI'. As a matter of fact, the most-favoured-nation clause is at present applied to almost all agreements. 'Ever since the initial negotiations', writes M. Nogaro, 'it was realised that, to obtain the benefit of the most-favoured-nation clause, it was necessary to agree to this clause in regard to all products of real interest to the other party. It was subsequently granted in a general way by means of reference to a given article of an earlier agreement. In the long run, the very French negotiators for whom the primary consideration had been to free French trade from the servitude of the most-favoured-nation clause were precisely those who contributed to its most explicit, fullest and most liberal definition in the recent conventions. . . . As for the intermediate tariffs, they were gradually eliminated by the implacable functioning of the most-favoured-nation clause' (NOGARO: 'Le Régime douanier de la France', page 143).

"The third—and particularly significant—example of a return to the most-favoured-nation clause is the well-known case of the United States of America. It will be remembered that this country, up to 1922, had adopted the system of the so-called 'correlative advantages'. From the eighteenth century onwards, the United States had granted the most-favoured-nation clause only in the following conditions: to benefit by the advantages previously conceded to A, B must grant the United States further concessions corresponding to those made by A. This is what is currently known as the *conditional clause*. As a matter of fact, the United States, in view of their special circumstances, have but on rare occasions agreed to concessions in regard to their tariff—which is a single tariff. It is all the more remarkable that the United States should, in 1922, have renounced the formula hitherto applied and, during the past few years, have reverted to the unconditional most-favoured-nation clause, which has been included in the commercial treaties contracted by Mr. Cordell Hull with a series of States. It would seem that the principal reasons for this change lie in the disadvantages of the conditional clause for a country which mainly exports



Even in relations between a country which has established a monopoly of foreign trade and other countries, the need for a guarantee of equal treatment is felt on both sides. That is why all the commercial treaties concluded by a country such as the Union of Soviet Socialist Republics contain the most-favoured-nation clause. It follows that, once the smooth running of the international mechanism is re-established, no country will fail to claim equality of treatment, unless it is prepared to abandon export trade: and, inasmuch as that would mean economic isolation, the case may be regarded as purely theoretical.

The Economic Committee is well aware that this picture of the problem, drawn in the light of the special conditions prevailing to-day, may reasonably be regarded as incomplete and distorted: but in approaching the subject in this way, its aim has been to deal with the most pressing and most immediate aspects of the problem.

The Committee is at the same time conscious of the fact that, apart from the defective working of the international economic mechanism which is characteristic of the present time, other motives of a political and economic nature have influenced, and may continue to influence, the attitude of the Governments and of business circles towards the system of the most-favoured-nation clause.

In the following sections it is proposed accordingly briefly to consider the problem in the light of two groups of factors—namely, the present difficulties affecting the international movement of goods and, on the other hand, the long-standing controversies about the clause and its value. It appears desirable, however, to preface this study with a few observations which may throw light on particular aspects of the subject.

## II. Observations on Certain Aspects of the Most-favoured-nation Clause.

It has been pointed out above<sup>1</sup> that the clause, in its origin, was primarily applicable to Customs duties. It is true that clauses prescribing equality of treatment in the matter of import prohibitions and restrictions also occur commonly in treaties, but the interpretation of clauses of the latter type where quotas or import licences are in question has given rise to much doubt and dispute (as to this, see the section headed "Quotas", on page 13). Occasionally also clauses occur which provide for most-favoured-nation treatment in respect of the goods of the parties in absolutely general terms. Broadly it may be said that the clause, in its common forms, implies a *right to claim immediately, as of right and without compensation, all reductions of duties and charges (and sometimes also favours and advantages of other kinds) accorded to the nation most favoured in Customs matters, whether such reductions or concessions result from autonomous action or from Conventions concluded with third countries.*

This is what is generally known as the *unconditional and unlimited* clause. The unconditional clause is *unlimited*, when it is applicable to *all* goods traded in between the two countries concerned. It may, however, be limited to particular categories of goods<sup>2</sup> while remaining unconditional.

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manufactured products, following a period in which its principal exports were raw materials and agricultural produce.

"At all events, these three examples are a striking illustration of the difficulty, not to say impossibility, of not applying the most-favoured-nation clause in a system of public law confirming the equality of States.

"The adhesion of the United States to the most-favoured-nation clause is in—so—far of primary importance: it may be said that, henceforth, two of the greatest trading Powers of the world—the British Empire and the United States—consider the most-favoured-nation clause as an essential element of their commercial agreements with other Powers. It is impossible to underestimate the importance of this fact. The vast trade carried on by these two great communities, their rôle as producers of raw materials and agricultural produce invest them with a situation which may be described as preponderant in international commercial relations as a whole. Their manufacturing capacity, the facilities provided by their vast home markets as regards the possibility of reducing cost prices are also factors which weigh heavily in the balance of commercial negotiations."

<sup>1</sup> See pages 5 and 6.

<sup>2</sup> See what is said below with regard to the *conditional* clause, page 24.

As briefly explained in the previous chapter, the essential purpose of the clause is to give the exporter a guarantee that his goods will be treated on a footing of complete equality with those of any other foreign competitor upon their importation into the country of destination.

The clause does not, therefore, imply any privilege, as the expression "*most-favoured-nation clause*" might suggest, but merely a guarantee against any adverse discrimination in connection with the conditions under which the goods are imported into a given country.

The clause is not, however, a means of equalising conditions of competition between different consignments of similar goods arriving from different countries in a given market. In subjecting all such goods to the same duties, it leaves unaffected the differences of price resulting from the inequality of the conditions under which the different consignments have been produced : the same inequality obtains even in the national market.<sup>1</sup>

2. It follows from what has been said that the clause is not necessarily associated with any particular type of commercial policy, and that it does not directly influence the level of Customs duties, since the latter remain the same for all goods, whatever their origin. It is not, therefore, accurate primarily to represent the clause as an instrument of free trade policy, as is frequently done. The history of trade policy shows that the clause has been accorded indifferently by countries with a liberal trade policy and by ultra-protectionist countries.

3. It cannot, however, be denied that, given normal economic conditions in which Customs duties represent the only form of protection practised, the clause actually operates, by force of circumstances, in the direction of gradual and progressive lowering of the general level of tariffs.

This very important—but not essential—function of the clause will be better understood, if the atmosphere in which foreign trade was conducted down to the world war is borne in mind.<sup>2</sup>

The curve of international trade between the years 1860 and 1914 was continuously upwards.

Each year, foreign trade played an increasingly important part in the economy of the majority of countries. The desire to develop exports was accordingly apparent even in the case of countries in which national production was protected in a relatively far-reaching manner. Every country had a vital interest in securing the same import conditions as its competitors in foreign markets ; and this contributed largely to the general adoption of the most-favoured-nation clause. But this motive—the desire to export large quantities of particular products—led the different countries, in concluding commercial treaties, to make tariff concessions on a considerable scale as a means of obtaining correspondingly large export openings. The need for equality of treatment made the clause essential : the need for expansion of exports made the reduction of tariffs inevitable : and the clause made the effects of such reduction general. Accordingly, the lowering of tariffs and the operation of the clause, though not necessarily connected, proceeded for a long time on parallel lines. This was a fortunate circumstance, since the operation of the clause without lower tariffs may be without much positive effect, and may only ensure that all countries will be treated equally unfavourably.

Thanks to this combination of circumstances, the value of the clause continued to increase, affording, as it did, the opportunity of benefiting by future concessions as well as by past

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<sup>1</sup> See in this connection the following passage from Professor Rist's report already quoted : " The clause may be compared with the abolition of internal Customs barriers in a given State. Such abolition constitutes a principle of public law providing for the juridical equality of all citizens in their transactions with whatever part of the territory. At the same time, it constitutes a principle of economic organisation, in so far as it determines a distribution of production and trade different from that entailed by the existence of internal Customs barriers."

<sup>2</sup> The relations between the spread of the use of the clause and the development of foreign trade have already been set out in the note by the Secretariat headed " Evolution of Commercial Policy since the Economic Crisis ", which will be found in the annex to the Report of the Economic Committee to the Council on the Work of its Forty-first Session (document C.353.M.165.1934.II.B).

reductions. It became, after a fashion, an object of negotiation for its own sake, and was usually accorded only as the crowning concession in treaties regarded as otherwise satisfactory by both parties. There can be no question that the operation of the clause in this sense had a considerable influence in the direction of progressive and general reduction of Customs duties.

But the two chief commercial countries—the United Kingdom and the United States—remained outside the movement, since they refrained from concluding tariff agreements. The absence of the United Kingdom was not much felt; for the United Kingdom followed a free trade policy. On the other hand, the absence of the United States, which made no tariff concessions and would only accept the clause in its “conditional” form,<sup>1</sup> was a considerable obstacle to the development of international trade. After the war, the United States adopted the principle of the “unconditional” clause: but, as they did not at the same time adopt a policy of tariff agreements, the clause—for which they invariably pressed—enabled them to continue to impose duties, which were in some cases prohibitive, without fear of discrimination, while they had the benefit of all concessions made to one another by other countries.

The dissatisfaction resulting from this policy—to which, from the legal point of view, no exception could be taken—and the criticism of the clause to which it gave rise at a time when the clause was being commonly applied are proof that, in general, the operation of the clause was regarded as going beyond the scope of a mere act of defence against discrimination, and that it was associated, in fact though not as a matter of law, with a general tendency in the direction of moderation in the matter of tariff protection.

It would, however, be going too far (as already stated) to suggest that the adoption of the clause implies adherence to a definitely liberal policy. In its legal sense, it implies only equality of treatment: but, in practice, it could not offer equality of treatment except in a world in which protectionist tendencies were not carried too far at the expense of export interests.

4. It is interesting to observe that recently this dual conception of the clause—first, as an instrument for ensuring equality of treatment and, secondly, as a means of moderating protectionist tendencies—has been rehabilitated, and nowhere more than in the United States and the United Kingdom, both of which countries have joined the ranks of those prepared to conclude tariff agreements on the basis of the principle that, to obtain the benefits of the clause, some sort of proof must be given that the beneficiary is worthy of them and ready to play his part in the process of trade recovery. This attitude presupposes that the clause is not in the normal way an isolated provision in a contract, but is an integral part of any commercial agreement concluded with a country ready to afford reasonable treatment to foreign goods, and, in particular, to refrain from discriminatory practices.

### **III. The Most-favoured-nation Clause as affected by Current Disturbances of the Economic Mechanism.**

#### **A. WEAKENING OF THE PRACTICAL EFFECTIVENESS OF THE CLAUSE.**

Reference has already been made to the profound disturbances of values represented by the disastrous collapse of trade and of prices which, by upsetting the bases of the balance of payments of the majority of countries, confronted these countries with the alternative, either of allowing their currency to depreciate (either in accordance with market fluctuations or to a new fixed level) to a point at which it could maintain equilibrium without restriction of trade, or of attempting to safeguard their currency and maintain it on a real or nominal gold basis by the imposition of restrictions on trade, of which the principal ones are quotas, exchange controls and clearings. To these defensive measures may be added the various forms of dumping, such as subsidies, tax concessions, bounties of different kinds, special exchange

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<sup>1</sup> See below, page 24.

treatment and so on. These devices are not new; but their use has been greatly extended since the crisis as a means of increasing the active, and decreasing the passive, elements of the trade balance by forcing exports. There will be found below a study of the effect of some of these anomalous practices on the operation of the most-favoured-nation clause; but it is already apparent that the drying-up of foreign trade—at first the cause, and later the effect, of the anomalies in question—was bound to deprive the clause of a great part of its value.

In the distressing condition of the national economy, the interests of the industries working primarily for internal consumption have everywhere come to occupy the first place.<sup>1</sup> Many Governments endeavour to avoid the consequences of large imports of foreign goods at continually falling prices, which can only result in further disturbance to the already shaken structure of national economy. Similar conditions operating in other countries confront the export industries with obstacles of every kind and destroy their power of expansion. It is obvious that, under these conditions, the negative aspect of the clause is thrust into prominence. The opinion spreads that the clause becomes dangerous to concede and of dubious advantage when obtained, in the face of prohibitions, quotas and foreign-exchange controls, the effect of which is to render illusory the guarantee of equality of treatment which the clause purports to give.

At the same time, a Government adopting this point of view finds it necessary to limit the effects of its concessions to the country with which it is negotiating, and is at pains to prevent any third country from enjoying gratuitously, in the market of the latter, facilities which it has itself obtained only at a heavy price. This means that extension to third parties of facilities granted to one another by two negotiating countries tends to be regarded as no longer justified on an automatic and gratuitous basis.

The first step, therefore, is the relegation to the background of interest in exports as a result of the movement for ensuring increased protection for national production. As, however, a certain minimum of exports is indispensable, the same factor which at times of expansion of world trade operates in favour of equality of treatment now operates in the opposite sense. When its markets are continually shrinking, a country will often attempt by special arrangements, generally on a compensation basis, to reserve as large a share as possible for itself, resorting for the purpose to the various measures (quotas, foreign-exchange control, etc.) referred to above. At first they are regarded as an unavoidable necessity; later, they are employed as a means of pressure to eliminate every form of import, except under "compensation", and to barter such imports as are inevitable against equivalent openings for exports.

In this process, the most-favoured-nation clause can play no part, since States are led to feel that, at any rate in the actual circumstances and for the time being, they can in any case constrain the other countries with which they are negotiating to accept a certain quantity of their products. It is true that the development of events often vitiates such calculations, but we are here concerned with the underlying intentions of the policy, not with its practical outcome. In this policy of balanced trade, the principle of equality is replaced by the principle of reciprocity in the form of the mutual concession of differential advantages; while, over and above these economic factors, the powerful group of psychological forces covered by the expression "nationalism" exerts an almost irresistible influence in favour of autarchy.

## B. MAIN OBSTACLES TO THE OPERATION OF THE CLAUSE.

### I. Quotas.<sup>2</sup>

In the absence of clear and explicit stipulations, the legal question whether quotas are compatible with most-favoured-nation treatment may be answered in various ways. But, in any case, it is now clear that quotas, no matter how excellent may be the intentions of the

<sup>1</sup> This section repeats to some extent ideas already embodied in the note of the Secretariat on "The Evolution of Commercial Policy since the Economic Crisis", which will be found as an annex to the Report of the Economic Committee to the Council on its Forty-first Session (document C.353.M.165.1934.II.B).

<sup>2</sup> See, in particular, HABERLER: "Liberale und Planwirtschaftliche Handelspolitik", 1934; and LORIDAN: "L'élargissement du commerce international", 1935.

countries imposing them, necessarily compromise the very object of the clause, which is equality of treatment.

Up to the present, no system has been discovered by which quotas can be allocated without injuring the interests of countries entitled to benefit under the most-favoured-nation clause. The three principal methods tried up to the present are :

1. The so-called "arithmetical" method, by which all countries may import the same quantities of a given commodity. *Summum jus, summa injuria*. This method tends to give artificial encouragement to imports from countries which export little and where costs of production are high, to the detriment of countries that enjoy natural and economic conditions favourable to exportation. Consequently, this solution was speedily abandoned.

2. What is known as the "proportional" method has been held to be more in keeping with the spirit of the clause. Under this method, each country is allowed to import, in the case of any given product, a quantity representing a definite proportion of the total quantity imported during a basic reference period. For very many reasons, however, the choice of a suitable basic period is a very difficult matter and gives rise to disputes of many kinds. Moreover, in view of the rapidity with which, at the present time, changes take place in production and sale conditions in the various countries, it is impossible to discover, among the statistics of the past, a basis which satisfies *equally* the *present* needs of all countries. This method, though it has no direct connection with the clause, for a fundamental reason that we shall explain later, is nevertheless the only one which can ensure as equitable an allocation as the existence of quotas allows.

It should, however, be pointed out that, at present, quotas are frequently allocated in accordance with the specific stipulations contained in commercial treaties.

3. The third method is to fix a total quota of permitted imports without allocating it among the various countries, and leaving all comers to compete for it. This method might be regarded as that which is least contrary to the principle of the clause, but, for practical and administrative reasons, it has seldom, if ever, been applied in this crude form. In a few instances, however, a variant has been employed, which consists in giving licences to importers to import given quantities, but leaving it to their discretion to decide from what source they will import.

Apart, however, from the impossibility of discovering a satisfactory method of allocation, the fundamental difference between the most-favoured-nation system and the system of quotas lies in the fact that the former is specially applicable in a time of expansion of trade, or at least potential expansion, whereas the latter belongs rather to a state of stagnation or retrogression. The two are thus entirely opposed to each other, though the difference between them may vary according to the spirit in which the quota system is applied.

The clause actually applies to Customs duties, and these duties merely increase the price. Subject to the payment of the forced contribution, the clause does nothing to check the growth of imports, the amount of which thenceforth is determined by variations in supply and demand. Quotas, on the contrary, abolish the influence of price by acting directly on quantity. The system of the clause is essentially dynamic, whereas that of quotas is essentially static.

True, in some quarters it is pointed out that, by its very nature, the quota system is the system which best accords with the present relatively static condition of international trade. But this means that international trade, and with it the most-favoured-nation-clause system, can only recover its strength by a gradual extension of quotas leading finally to their disappearance. In support of this argument, it may further be pointed out that the clause, by subjecting all countries which supply a given commodity to the same Customs treatment, allows free competition between these countries, whereas the quota system, by fixing the quantities which may be imported, crystallises the situation and thereby stereotypes the

competitive relationship between the countries concerned. Lastly, it may be added that, in practice, the quota system often deprives Customs duties of their importance and thus prevents the clause from operating in its own sphere.<sup>1</sup>

## 2. *Foreign-exchange Control.*<sup>2</sup>

The above remarks concerning quotas apply with even greater force to foreign-exchange control, when such control is applied, not only to the movement of capital, but also to imports of goods, so that the State thenceforth decides whether it will place the necessary exchange at an importer's disposal to pay for his purchases abroad, and the amount which will be allowed him. Foreign-exchange control in this case is simply a universal application of the quota system and is even more certain than the latter to render guarantees of equal treatment illusory. What, indeed, is the use of such a guarantee and what benefit can there be in having exchanged, perhaps, a number of concessions for the right to certain quotas, if at the time of importation the unsatisfactory state of the balance of payments leads the importing country to restrict still further the amount of foreign exchange destined for imports? Again, even when the goods are imported, foreign-exchange control may prevent the exporter from receiving payment for his goods, in spite of the solvency and good faith of the purchaser. It is true that, by various arrangements, efforts are made, in the matter of foreign exchange, to secure "equitable treatment", that is to say, treatment no worse than is absolutely indispensable, taking the situation of the debtor State into account. But clearly such "equitable treatment" does not afford the degree of security which the clause is deemed to provide.

Moreover, the need for limiting the outflow of foreign exchange inevitably leads to that discrimination which it is the clause's aim to combat. A country in monetary difficulties will endeavour, before all else, to utilise its small stock of foreign exchange in order to purchase the things it regards as most indispensable—certain raw materials, certain foodstuffs, certain semi-finished products, etc. Other imports, regarded as "avoidable", are relegated to the background. Thus a sort of classification of imports is established, foreign exchange being reserved for certain categories of goods and being granted sparingly or refused in the case of others. Among the latter are finished products and the whole range of so-called "luxury" articles, the term "luxury" being extended to cover an ever-wider range of articles as the difficulties of the importing country multiply. Though it is impossible to find fault with the importing country for the discrimination thus made between various categories of goods with a view to protecting its exchange rate, there can be no gainsaying that this discrimination between goods inevitably leads to discrimination between countries. And this discrimination, in the first instance involuntary, becomes systematic as soon as a large part of the import trade is conducted solely on a compensation basis. Obviously, in these conditions, equality of treatment, which the clause is intended to embody, is seriously compromised.

## 3. *Clearing Agreements.*<sup>3</sup>

Foreign-exchange control leads in most cases to the conclusion of clearing and other similar agreements, the object of which is to provide for the settlement of international payments by means of compensation; and these agreements may, by the force of circumstances, come into conflict with the principle of equality of treatment. They often involve a special regulation of trade relations between the contracting countries on a basis quite different from that which governs their relations with the other countries. In some cases,

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<sup>1</sup> These remarks concerning the incompatibility of import quotas with the clause also apply in principle to *Customs quotas*. These quotas limit the agreed Customs concessions to definite quantities, and are therefore opposed to the conditions necessary for the free development of trade under which alone the full operation of the most-favoured-nation clause is possible. The Economic Committee has already explained its views regarding Customs quotas. (See "Recommendations of the Economic Committee relating to Tariff Policy and the Most-favoured-nation Clause", Geneva, 1933 (document E.805).)

<sup>2</sup> See "Enquiry into Clearing Agreements", League of Nations, Geneva, 1935.

these agreements result in an increase of trade between the contracting countries. Clearing agreements generally stimulate purchases by a country with a weak and controlled currency, because its merchants are led, owing to the absence of free currency, to buy more in the other contracting country, even if prices in that country are less favourable than those elsewhere.

Moreover, under the system of clearing and compensation treaties, the sale of goods is often made to depend on the purchases of other goods. Further trade between the contracting parties is artificially stimulated by the fact that clearing surpluses are generally not transferred, but are utilised in the debtor country. Furthermore, clearing is sometimes employed in countries with weak currencies as a means of correcting the trade balance, or even of acquiring a credit balance, which will make it possible to dispose freely of a certain surplus of foreign exchange for the purpose of meeting foreign obligations, liquidating frozen claims, and effecting necessary purchases in third countries and particularly for acquiring raw materials. The countries in question accordingly endeavour to obtain a variety of special facilities by negotiation. Similarly, continuous negotiations between the national banks to ensure the liquidation of balances and to fix the rate of exchange for reciprocal payments lead to various arrangements to facilitate the settlement of accounts—inevitably at the cost of third countries. It is in this way, for instance, that reciprocal trade is adjusted ; additional quotas are granted for imports from the debtor country, special conditions are conceded in order to hasten the liquidation of surpluses, privileged treatment is reserved for nationals of the contracting country in such matters as the authorisation of private compensation arrangements, etc. The following example of the procedure sometimes adopted in these agreements demonstrates the extent to which they may conflict with the principle of equality of treatment, even in Customs matters. Country A buys certain products in country B. A's normal exports to B not being sufficient to ensure the settlement of the debt resulting from these purchases, country B becomes creditor for a sum expressed in the currency of country A. Country A then reduces, for this credit, the rate of exchange in relation to the currency of country B, in order to encourage additional imports of goods from country A. The duties levied on these goods come, it is true, within the scope of the clause, but competitive relations are entirely distorted.

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There is no need to emphasise further the effect which the present anomalies produce on the system of equality of treatment ; everyone knows that, if that system is not giving satisfactory results at the present time, it is not because it has ceased to be useful or necessary, but simply because disorders in the economic mechanism of the world prevent its operation. This is not surprising : the system of the clause is naturally based on monetary stability, freedom of currency exchange, the free circulation—as regards quantity—of goods, and the existence of increasing trade and of triangular trade ; in short, on conditions which exist more or less in a large part of the world. The system is, in fact, incompatible with a situation characterised by a static or a contracting tendency in trade, by the purely bilateral and compensatory trade arrangements, by the abolition of the international function of currency, and by material obstructions to the circulation of goods, such as at present obtains in most European countries.

**C. EFFECT OF THE PRESENT SITUATION ON THE RELATIONS BETWEEN COUNTRIES WHOSE TRADE IS NOT SUBJECT TO QUANTITATIVE LIMITATION OR MONETARY RESTRICTION AND COUNTRIES WHOSE TRADE IS THUS RESTRICTED.**

Whereas, as has already been shown, the clause may quite well be applied in relations between countries which have devalued their currency but continue to base their trade relations on the principle of free competition—only tempered, generally speaking, by Customs duties—it cannot govern fully relations between these countries and countries which subject their imports to a system of quotas, foreign-currency control and clearing. In fact, the

reciprocal concessions which the two groups of countries concerned can grant one another differ in character. While those of the first group—mainly Customs concessions—are dynamic and afford trade a possibility of development, those of the second group consist mainly in the consolidation or mitigation of quantitative limitations; they put a check on trade and introduce a static factor.

Thus there are two fundamentally different policies in operation which it is difficult to reconcile.

This is not to say that no commercial agreements between countries pursuing these divergent tendencies are possible; in fact, a number of such agreements exist, and, though they are inevitably in the nature of compromises, they appear, in general, to function more or less to the satisfaction of the parties. In this connection, it should be remembered that the United States Government recently concluded a number of agreements making the application of the clause dependent upon specific guarantees, as regards restrictions of the kind referred to above, in the hope of bringing about a more general development of trade in spite of the restrictions, and of contributing, by means of such arrangements, to a gradual return to more normal trade conditions.

It would be a mistake, moreover, to conclude from the above that any stipulations providing for the system of the most-favoured-nation clause in agreements between countries of the two groups mentioned are necessarily wholly ineffective. In many such cases, the stipulations in question retain their value at least to the extent of ensuring that non-discrimination continues to be practised in the matter of Customs duties and the like, thus limiting the need for adopting *ad hoc* measures of a different type in order to ensure, as far as possible, the maintenance of the principle of equitable treatment.

There is nevertheless a clearly marked opposition between the two policies in question, which is in large part responsible for the stagnation of international trade and the diminution in the scope of the principle of equality of treatment.

#### **IV. Divergent Opinions and Proposals for the Revision or Abandonment of the Most-favoured-nation Clause.**

The present section contains a summary account of the controversies between supporters and opponents of the clause and the various means suggested to remedy its real or imaginary shortcomings.

##### **A. POINTS OF CONTROVERSY.**

###### ***1. Various Criticisms of the Clause.***

As a matter of principle, the most-favoured-nation system has always been attacked by those whose chief concern is the protection of their home markets; recent developments in international commercial relations have only strengthened and multiplied their attacks. Their chief objection to the clause is that, in their opinion, it tends to promote free trade, or acts as an instrument of free trade. As Customs reductions are extended to all countries, the result is a gradual decrease in the protection accorded to the national economy. Moreover, the clause—particularly when accompanied by the consolidation of Customs duties—deprives countries of their freedom of negotiation; for it renders valueless for bargaining purposes certain concessions which might otherwise lead the other party to offer advantageous terms, seeing that these concessions are automatically extended to all countries to which the clause applies. It prevents the negotiator from obtaining advantages through the possibility of discrimination, and from using the same concessions several times over for different negotiations, in order to derive the maximum possible advantages from the successive negotiations. Moreover, it precludes the lowering of duties in the case of a country whose competition is not feared, because other countries that are formidable competitors benefit thereby without having to grant any corresponding advantage.



The criticisms advanced in some other quarters, where attention is directed not so much to the protection of the home market as to the expansion of export markets and foreign trade, are entirely different ; but they rest in part on the same theoretical basis.

In these quarters, it is recognised as a rule that the clause worked well so long as the commercial policy of most of the principal countries was directed towards increased freedom of trade, and so long as tariff concessions formed the main subject of negotiation. But it is claimed that, once the majority of countries adopted a marked policy of protection, the clause ceased to operate favourably and even became an additional source of dissatisfaction. When the slightest Customs concession is regarded as a heavy sacrifice, the principle of equality of treatment militates against the removal of the restraints on trade, and indeed furnishes an additional argument in favour of higher tariffs.

The following arguments<sup>1</sup> are adduced in support of this contention :

In the case of an autonomous (not negotiable) tariff, equality of treatment for all countries leads to the raising of import duties to a higher level, since their level will be fixed with reference to the conditions of production of the rival whose competition most seriously affects the national economy. Thus the clause leads to a " door closed to all alike ".

Moreover, as has often been pointed out—in particular with reference to the policy formerly followed by the United States—countries with a high autonomous tariff avail themselves of the clause solely in order to obtain all the advantages which the other countries concede to each other, but without ever being obliged to grant any of those advantages themselves.

In the case of tariff treaties, the clause, it is claimed, will hinder reductions of duty, for the following reasons :

(1) A country that would be prepared to grant certain tariff concessions to another will hesitate to do so if they are automatically extended to all countries ;

(2) A country will refrain from granting tariff reductions in order to obtain others in exchange when it knows that, if it only waits, it will obtain the benefit of the reductions that will be granted to third countries ;

(3) The value of a concession granted to a country is lessened owing to its being extended to other countries ;

(4) The benefit of an advantage granted to a given country may go mainly or exclusively to a third country ;

(5) A country will not derive, from a concession it is prepared to make, all the advantages the concession might secure for it, because, while granted to a co-contracting country in return for compensation, the concession will be extended gratuitously to all countries that refuse to " pay " to get it.

These real or imaginary defects in the clause are held responsible in certain quarters for the fact that tariff negotiations no longer as a rule lead to such large and numerous reductions as in the past and are often confined to a few minor concessions applying to products for the trade in which the two countries in question are particularly favourably situated. It is added that this procedure, which consists rather of the system of reciprocity than a regime of general equality, is facilitated if the tariff headings are narrowly defined.

## 2. *Brief Examination of these Criticisms.*<sup>1</sup>

In reply to the first argument of the opponents of the clause, that it is an instrument of free trade policy, appeal is made to the facts of past experience. The clause has been used in its present form, especially since the conclusion of the famous Cobden-Chevalier Treaty,

<sup>1</sup> See in particular W. LORIDAN : " La clause de la nation la plus favorisée, etc. ", *Revue économique internationale*, May 1935.

which inaugurated a period of liberal trade policy. During this period, when tariffs were as a rule consolidated, frequent reductions in duty were made and then were automatically extended through the operation of the clause to all countries entitled to them. It is therefore because of the direction taken by the development of commercial policy during this period (as described in Section II) that liberalism came to be considered as one of the essential merits of the clause.

The other arguments used in quarters principally concerned with the protection of the home market tend to show in particular that differential duties<sup>1</sup> offer advantages as compared with the system of equality of treatment and that the clause restricts the freedom of action of the negotiators. In reply to the first group of these arguments, the following considerations have been put forward :

(a) It is, in practice, of no importance for the protection of the home market whether duties are lowered by means of a general or a differential reduction ;

(b) The grant of differential advantages is calculated to bring about a position of political and economic dependence in the State receiving such benefits, especially if it is a weak country ;

(c) Third countries will scarcely be inclined to tolerate such discrimination and may reply by retaliatory measures ;

(d) Lastly, each country will hesitate to pay a high price for differential concessions which may be cancelled at any time by greater advantages accorded to other suppliers.

As regards the charge that the clause hinders a country's freedom of action in applying its trade policy, there is no reason to suppose that the inclusion of the clause will appreciably decrease the value of the concessions granted. Indeed, these concessions are in most cases of interest mainly to the country which has demanded them or which, by granting equivalent concessions, has obtained equality of treatment in this respect. It rarely happens that a country wishing to negotiate a commercial agreement finds that all its wishes have already been covered by concessions granted to third States. Moreover, every country is in a position to obtain the maximum concessions in exchange for Customs reductions which it is requested to make, either by negotiating simultaneously with the various countries concerned and only publishing the results when all the negotiations are concluded, or by making the granting of the clause in each case dependent on particular concessions. It should also be pointed out that there are not, as it were, any advantages " obtained gratuitously through the operations of the clause ", since such advantages are compensated by subsequent reductions enjoyed by the State which grants the clause, or at any rate by the guarantee of non-discrimination.

The tactical considerations referred to above are, moreover, of no great interest in times of marked protectionism ; for each State is then inclined to increase its duties before entering into any negotiations in order not to be compelled to reduce in any way the general level of its protection.

The arguments adduced against the clause by advocates of the greatest possible freedom of trade have usually more force than those which have just been refuted. For instance, it can scarcely be denied that in periods when prohibitionist tendencies predominate, the clause tends to increase the reluctance of Governments to reduce Customs tariffs. This we must admit to be true, even if we are not prepared to accept all the arguments generally advanced to prove the harmfulness of the clause to the conclusion of tariff treaties. It will therefore be sufficient to add the following remarks :

(a) The replacement of the system of equality of treatment by that of differential duties sometimes defeats the objects pursued by the advocates of freer trade. This is the

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<sup>1</sup> This term seems more suitable than the expression " preferential duties ", which may be misunderstood as it is currently employed to denote the preferential reductions in force between countries connected politically and economically, such as those of the British Empire. The expression " differential duties " is understood to mean simply tariff reductions strictly limited to the contracting party and not forming part of a system of preference established within a group of the kind indicated.

case particularly when the imposition of differential duties favours a country which is unable to meet the competition of third countries in respect of the cost of production of the products in question.

(b) The extension of a concession to a third country is in most cases a secondary matter, since, in practice, the country asking for the reduction is also the one which supplies a considerable part of the products in question.

(c) The case of a reduction which benefits mainly a third country is very rare and can only be the result of an unfortunate choice on the part of the negotiators.

On the other hand, in reply to the charge that the clause leads to a duty being fixed on a product in accordance with the conditions of competition of the most formidable competitor, it has been stated that, according to the free-trade doctrine, it is precisely the duty applied to the country enjoying the most favourable conditions of production which is of importance. The desire of favouring, as against such a country, the goods of a country incapable of producing under satisfactory conditions would be contrary to the aims pursued by the advocates of freer trade.

Lastly, some critics object to the clause on the ground that it provokes evasion and leads to the adoption of unfair practices, disguised particularly in the form of a detailed classification of tariffs; but it has been pointed out that these critics have never been able to produce sufficient evidence that such methods have, in practice, really been used to any considerable extent in order to evade the obligations under the clause.<sup>1</sup>

Moreover, a number of important States have inserted express stipulations in their commercial agreements providing for effective guarantees against such practices.

Consequently, although it is true that, during periods where protectionist tendencies predominate, the clause may occasionally accentuate such tendencies, it is very far from really exercising the harmful influence on international relations which certain writers attribute to it.

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In the preceding paragraphs, we have summarised the most common arguments adduced for and against the clause. These arguments are only pertinent when general economic conditions enable the clause to operate normally in a commercial system based essentially on tariff duties.

The reader will supplement this brief statement by the considerations contained in the other parts of this survey.

It is certain that, if the unconditional clause is to continue to serve as an essential guarantee for export trade, all the parts which make up the mechanism of world economy must be allowed to operate unchecked. In general, the value of the clause depends wholly on the use made of it by the various States and on the circumstances in which it is required to operate.

Experience shows that, so long as commercial relations can develop normally and so long as the standard of living rises and needs and the means of satisfying them continue to increase, the equality of treatment guaranteed by the clause is not only a necessity, since every country demands it, but is also a valuable aid to the development of trade.

Moreover, the importance of the principle of equality of treatment is brought out by a consideration of the systems which the opponents of this principle propose to establish in its place.

## B. ALTERNATIVE METHODS PROPOSED IN SUBSTITUTION FOR THE CLAUSE.

### I. *The Method of Exclusive Mutual Concessions.*

In theory, the method which is diametrically opposed to the most-favoured-nation clause is that of exclusive mutual concessions. Under this system, which has again found ardent supporters in a number of countries, each contracting party limits its tariff or other concessions

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<sup>1</sup> In this connection, reference may be made to the work carried out by the Economic Committee on the question of similar products and the most-favoured-nation clause (see document E.673, Geneva, 1931).

to an extent considered equivalent to the direct concessions which it receives from the other contracting party, without these concessions being extended to third parties through the operation of the most-favoured-nation clause. There is no legal relationship between the Customs duties fixed in the various treaties, nor is there any obligation limiting the right of States to establish in their mutual relations any discriminations as against third countries that they may consider necessary. If such a system were generally adopted, the consequence would clearly be detrimental to every country, introducing into international economic relations a kind of anarchy. In particular, States maintaining manifold and varied trade relations with the rest of the world, and possessing large industries requiring external markets, would quickly become conscious of all the drawbacks of the discrimination to which they had exposed themselves by concluding treaties of exclusive reciprocity.

Seeking to remedy this situation, States would be obliged either to grant equality of treatment—that is to say, to revert to the clause—or to lay themselves open to exhausting tariff wars which would still end in a settlement on the basis of non-discrimination.

A development towards the generalisation of this system, highly dangerous as it would be for the large countries, would be fatal for the small, which possess no effective means of countering the discrimination to which they would be subjected.

Recent economic history supports this view by showing instances of powerful countries which, after trying to practise such a policy, have come to realise its disadvantages and have ultimately abandoned it for the system of the most-favoured-nation clause.<sup>1</sup>

But even more interesting than these lessons from the past are the inferences to be drawn from the consequences of the policy of exclusive mutual concessions as practised by a number of States during the present period of depression. Certainly, not a single one of these States can assert that this policy has helped to increase the welfare of the population, to increase the volume of trade, or to render its relations with the rest of the world more harmonious. On the contrary, even in countries where this policy has a large number of outstanding and influential supporters, the views of those advocating a gradual return to the principle of equality of treatment find growing favour with the authorities.

In this connection, it may be remarked that the new attitude (examined above) towards the most-favoured-nation clause taken up by the United Kingdom and the United States of America will make it increasingly difficult for countries practising the method of exclusive mutual concessions to persist in that policy.

When we have seen an end of the present troubles, which have led many countries to regard "bilateralism" and compensation as essential for national existence, it is more than probable that the system of exclusive mutual concessions will quickly cease to be an important element in commercial policy.

## 2. *Compensatory Duties.*<sup>2</sup>

A Customs duty is most frequently designed to make up the presumed difference between the cost of production in the home country and the cost of production abroad. It is thus a "compensatory duty". But in recent years the idea of compensation has been taken up and defined in a sense which places it in opposition to the principle of equality of treatment.

According to this new conception, which has found in important countries staunch supporters among influential businessmen and theorists alike, "compensatory" protection should no longer be given by means of uniform duties applicable to goods regardless of their origin, but by a series of tariffs lying between a fixed minimum tariff and a maximum tariff,

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<sup>1</sup> See, on this subject, the chapter of the report by M. Rist quoted above.

<sup>2</sup> See in particular :

LORIDAN — "La clause de la nation la plus favorisée" (*Revue économique internationale*, May 1935).

PICARD — "A la recherche d'une politique économique" (*Revue économique et parlementaire*, December 1932).

DUCHEMIN — "La crise mondiale et la politique douanière et contractuelle de la France" (*Revue politique et parlementaire*, January 1933).

in which account would be taken both of the specific differences between production in the exporting countries and in the importing country and of the advantages obtained by the latter in the course of commercial negotiations carried on with the former.

It is hard to imagine how such a system could work in practice, as it would presuppose for each kind of goods the fixing of variable duties, which would be imposed in accordance with different criteria for different importing countries. Moreover, this method would hardly permit of the conclusion of tariff agreements, since the countries with which the negotiations were carried on would ask precisely for a reduction of duties on the goods they produced cheaply, whereas, according to the doctrine of compensation, the duties on such goods would have to be highest.

There is, lastly, reason to believe that, if capable of application and actually applied, such a method would probably result in completely stifling international trade, which gets its chief stimulus from the difference in conditions of production in the various countries.

But, even if such a system could work, absolute compensation would not then be ensured, because foreign purchasers, being no longer able to benefit by the reduction of their cost price, would fall back upon competition in quality and, instead of selling to the foreign country the *same* article at a lower price, they would sell a *better* article at the *same* price. In order to obtain the desired compensation, subsidies would have to be given to goods of poor quality.

Furthermore, the history of the intermediate tariff introduced in France in 1892, as outlined by M. Rist in the report already quoted (see page 9, continuation of footnote), shows that such a system is very difficult to apply.

### 3. *Inadequacy of the Most-favoured-nation Clause when Conditions of Current Competition are too Unequal.*

But, in spite of the foregoing considerations, the theory of compensatory duties as described above still enjoys influential support, the reason being that, in certain countries, conditions of production are such as to upset all previous notions of competition in the world market and to endanger seriously the production of other countries, even in their home markets. Such a situation is clearly calculated to effect a profound change in the very bases hitherto underlying the application of the principle of equality of treatment.

M. Rist, in the report already quoted, classifies under three main headings the inequalities in the conditions of production which lead to this state of affairs :

- (a) Inequalities due to monetary devaluation ;
- (b) Inequalities due to differences in the home market (superiority of certain countries, for example, as the result of mass and standardised production) ;
- (c) Inequalities due to social conditions and the standard of living.

But there are countries where, particularly since the war, all these conditions exist together and thus help to bring about an immense reduction in prices of exports, with which, accordingly, the other countries cannot possibly compete.

Undeniably, the clause applied without any corrective under such unequal conditions of competition places the country granting it in a serious dilemma. If it raises its duties sufficiently high to meet this exceptional competition, it will cause an excessive rise in the price of the goods in question at home, and will at the same time, contrary to its wishes, exclude from its home market the goods coming from other countries, which cannot produce them at such low prices. If it merely imposes moderate duties, it will expose its home producers to competition greater than they can bear, and that, moreover, without any attendant benefit to exporters in the countries where prices are normal.

Obviously, it is for the countries concerned to deal with such circumstances as best they can. Many of them, as is well known, have devised special measures enabling them to cope successfully with such exceptional situations without forgoing, in general, the benefits conferred by the clause.

Moreover, these conditions, for the very reason that they are abnormal, are bound to change sooner or later, and to approximate more to those obtaining in other countries. They

are, in fact, the outcome of three essential factors—monetary depreciation, cheap labour and improvement of the technique of production. But it is not impossible that the advantage due to these three factors will tend to decline in course of time. Prices might reach equilibrium both through the depreciation of the other currencies and a change in costs at home; prosperity, the consequence of commercial success, might raise the workers' standard of living—and consequently their wages—and, lastly, the industrialists of other countries might gradually succeed in perfecting their machinery.

Hence the existence of exceptional competition from individual countries, though it may justify the application of particular measures as a temporary expedient, is no reason for overlooking the undoubted merits of the principle of equality of treatment.

#### 4. *Preferential Treatment as a Factor in the Formation of Economic Groups.*<sup>1</sup>

Very sharp attacks against the most-favoured-nation clause are made to-day by those who take the view that, on account of the changes that have occurred in the structure of post-war world economy, the old idea that States should be absolutely independent of each other commercially must be abandoned and that what is now necessary is the formation of large economic groups.

The formation of such *blocs* has hitherto been checked by the fact that the mutual facilities which countries disposed to form an economic group were ready to grant each other would have had to be extended automatically, through the effect of the clause, to all countries entitled to benefit by the clause. Nevertheless, the criticisms advanced under this head against the principle of equality of treatment are directed not so much towards its complete abolition as to securing the acceptance of a derogation from the clause, whereby the latter would not apply to preferential advantages granted to each other, for the explicit purpose of forming a single large market, by a number of countries politically or economically associated or occupying a geographical situation specially favourable to reciprocal trade.

The formation of such groups might, in the opinion of their promoters, exercise a happy influence on the development of international trade, if accompanied by certain guarantees to prevent it from threatening the trade of other countries, and if such a regional understanding covered a sufficiently large number of countries.

The advocates of such schemes call attention to the existence of such economic groupings as that constituted by the British Empire, a group whose historical origin and national character will not be disputed. Preferences granted within the Empire are excluded from the scope of the most-favoured-nation clauses of British commercial treaties. It is also a fact that a number of regional exceptions based on long-standing historical and economic association are already commonly recognised in commercial treaties. But the haphazard formation of fresh groups of neighbouring countries having no special historical or economic association would, it must be recognised, tend progressively to deprive the most-favoured-nation clause of its value.

Full Customs unions, which also are commonly recognised in treaties as an exception to the clause, would no doubt tend, by producing larger areas of unrestricted trade, to increase the prosperity of the areas concerned, thus making them eventually better buyers of other countries' goods; but merely piecemeal or partial preferences not amounting to Customs unions would give no such assurance, while, on the other hand, they would make a serious breach in the general regime of equality.

In some cases, special exceptions have been introduced by a number of countries, at any rate as interim measures, to overcome particular difficult situations. Yet any such exceptions would need to be hedged with safeguards to prevent them from becoming a danger to the trade of third countries.

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<sup>1</sup> This paragraph is not intended to refer to the multilateral agreements, open to the accession of all countries, concluded under the auspices of the League of Nations or based upon the recommendations of the Seventh International Conference of American States held at Montevideo in December 1933. The various aspects of the compatibility of the clause with the agreements of this type have already been examined in the above-mentioned report of the Economic Committee (Recommendations, etc., document E.805).

Much might be said one way or the other on the subject of the possible formation of great "geo-political" groups—e.g., of entire continents. In some directions, States members of such groups might expect to obtain from them, at any rate, certain immediate advantages, but, on the other hand, it is quite possible that these advantages might be outweighed by resulting inter-continental economic antagonisms; moreover, the formation of such groups would go far to deprive the most-favoured-nation clause of its universal character, and thus of its value. In any case, however, the formation of such continental *blocs* appears outside the realm of practical politics in present-day conditions.

The mere absence of recognition in commercial treaties of the legality of such groups, by way of exception from the most-favoured-nation clause, cannot be considered to constitute the real obstacle to the realisation of projects of this kind.

It would therefore seem illusory to believe that the mere introduction of a fresh exception could, in itself, help to solve the problems raised by the present state of world economy.

This illusion would be seen to be still greater if propagandists advocating such a fresh exception asked for it to be applied, not only to a preferential union of all European countries, but also to smaller groups consisting of only two or more of their number. Apart from the theoretical economic arguments habitually advanced against the idea of regional exceptions—arguments on which we need not dwell—it seems far from certain that such combinations would necessarily operate in favour of the restoration of healthy conditions for international trade. Not only are preferential duties which do not cause an increase in imports and a reduction of prices devoid of real and permanent value, but they afford no guarantee that the new regional groups so created would not continue, more tenaciously and more successfully, the protectionist policy previously followed individually by the States forming part of the group.

But here again, the difficulties which stand in the way of the conclusion of such agreements are difficulties of substance and not merely of a juridical order. For example, numerous countries may well be unwilling to give other countries what may be called a "blank cheque" allowing them to withhold most-favoured-nation treatment in ways and to an extent which could not be foreseen. In any case, if a multilateral economic convention were accepted by a substantial number of countries of economic importance, the attendant difficulties connected with most-favoured-nation treatment would, in practice, become relatively insignificant.

##### 5. *The Conditional Form of the Clause.*

The history of commercial policy contains several cases in which States not wishing either wholly to renounce the principle of equality of treatment or to accept all the consequences of granting the unconditional clause as described in Section I have sought to combine most-favoured-nation treatment with a system of special reciprocity. They have introduced into their commercial treaties a conditional most-favoured-nation clause stipulating that the advantages granted to a State in the matter of commercial policy in exchange for particular favours will be granted to the beneficiaries of the clause only in return for identical or equivalent concessions.

The Economic Committee has previously taken its stand against the application of this system and showed the dangers it involves for world trade;<sup>1</sup> nor has anything arisen since then to invalidate its judgment.

Moreover, it has very rightly been observed<sup>2</sup> that the granting of the conditional clause really amounts to a polite refusal to grant the most-favoured-nation clause, and that the real significance of this "conditional clause" is that it constitutes a *pactum de contrahendo*, by which the contracting States undertake to enter later into negotiations to grant each other certain advantages similar or correlative to those previously granted to third countries.<sup>3</sup>

<sup>1</sup> See document E.805, already quoted.

<sup>2</sup> VINER — "The Most-favoured-nation Clause", *Index*, January 1931.

<sup>3</sup> HABERLER. *loc cit.*

## V. Conclusions.

1. The most-favoured-nation clause and the system of equality of treatment which it is designed to establish constitute an essential guarantee for the maintenance and development of world trade.

In this connection it is important to note that the clause has in no way ceased to function, but still continues as the underlying principle governing commercial relations between many countries.

2. The clause loses most of its practical effectiveness when international commerce is subjected to quotas and exchange restrictions, clearings and compensation arrangements; but, even in these circumstances, it remains effective where Customs duties are concerned, thus narrowing the field in which it is necessary to devise other guarantees of equal or at least equitable treatment, which are essential if trade is to develop to the maximum extent possible under the cramping conditions now prevalent and if the diversion of the currents of trade from their natural channels is to be avoided.

3. In the long run, however, these abnormal measures for the regulation of trade—quotas, foreign-exchange control, clearing and compensation agreements—are incompatible with a developing and prosperous trade. What is needed, therefore, is not discussion of the merits or defects of the system of equality of treatment, but an effort to repair this fundamental injury to the mechanism of international trade at the earliest moment.

4. To discuss whether the general use of the most-favoured-nation clause will or will not prevail in the future is superfluous, for the simple reason that, as soon as currencies can again be freely negotiated and as soon as the circulation of goods is freed from restrictions as to quantity, no country will submit to discriminatory treatment. Wishing to ensure equality of treatment for itself, it will be obliged to grant such equality to others.

5. The introduction of an exception to the clause in favour of multilateral treaties for the formation of larger trade markets must be examined in the light of the Economic Committee's previous studies. It should be remembered, however, that the principal obstacle to the formation of such areas lies not in the existence of the most-favoured-nation clause—which is a contractual provision and therefore subject to denunciation—but in the absence of a movement of opinion strong enough to overcome the opposition to the realisation of such projects and still more in the fundamental objections which have been raised against the recognition of undefined exceptions to the general application of the clause.

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**Annex.**

**RECENT STUDIES OF THE MOST-FAVoured-NATION CLAUSE.**

- RIEDL :** La clause, etc., 1928.
- ALLIX :** La clause, etc., *Revue économique internationale*, September 1930.
- VINER :** The Most-favoured-nation Clause, *Index*, January 1931.
- RIEDL :** Die Ausnahmen von der Meistbegünstigung, 1931.
- ITO :** La clause, etc., 1931.
- NAUDIN :** Réflexions critiques sur la clause, etc., *Revue politique et parlementaire*, December 1932.
- DUCHEMIN :** La crise mondiale et la politique douanière et contractuelle de la France, *Revue politique et parlementaire*, January 1933.
- VEIT :** Meistbegünstigung and Präferenzsystem, *Deutscher Volkswirt*, February 10th, 1933.
- OUALID :** Les nouvelles techniques de la politique commerciale, *Revue d'économie politique*, 1933.
- COMITÉ ÉCONOMIQUE :** Recommandations concernant la politique tarifaire et la clause, etc., 1933.
- HABERLER :** Liberale und planwirtschaftliche Handelspolitik, 1934.
- HAUSER :** La paix économique, 1935.
- LORIDAN :** La clause de la nation la plus favorisée, 1935. L'élargissement du Commerce international, 1935.
- AMERY :** La clause, etc., *Revue économique internationale*, November 1935.
- PASVOLSKY :** Bilateralism in International Commercial Relations (*Harvard Business Review*, 1936).
- SOMMER :** Neugestaltung der Handelspolitik, 1936.
- RIEDL :** Aussenhandel und Währungsschutz, 1936.
- RIST :** Le passé et l'avenir de la clause de la nation la plus favorisée, 1936.
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