THE UNITED STATES, MEXICO AND THE NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

THESIS

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CHAPTER I

Introduction to Thesis

The North American Free Trade Agreement (NAFTA) is a rules-based document that sets out the principles and aspirations for free trade. As such the rules affirm that the three countries, the United States, Mexico and Canada are committed to promote employment and economic growth in their country through the expansion of trade and investment opportunities and through competition in global markets.

The subject of this thesis is based on this Agreement and the relationship between Mexico and the United States. The reason for selecting Mexico-US versus Canada-US, is that Mexico is not considered a developed country. What is important is the fact that an underdeveloped country such as Mexico has become a trading partner with the United States, whose economy is about nine times larger than Mexico's.

The thesis addresses the question why these two countries entered into a free trade agreement. It provides an analysis of the economies and the national interests of the two countries.

In order to understand the implications of the Agreement for Mexico and the United States, I have provided a synopsis of the agreement by chapter, and a summary of significant environmental provisions at the end. Also included are two appendices that discuss the maquiladora program and the side agreements.

The opening provisions of the Agreement formally established a free trade area between the three countries, consistent with the General Agreement on Tariffs and Trade (GATT). The basic rules and principles will govern the Agreement and the objectives served as the basis for interpreting its provisions. The objectives of the Agreement are to eliminate barriers to trade, to promote conditions of fair competition, to increase investment opportunities, to provide adequate protection for intellectual property rights, to establish effective procedures for the implementation and application of the Agreement and for the resolution of disputes, and to enhance trilateral, regional and multilateral cooperation.

Each country affirmed its respective rights and obligations under the GATT and other international agreements. For purpose of interpretation, the Agreement established that the NAFTA takes priority over other agreements to the extent that if there are any conflicting treaty obligations, exceptions to this general rule are provided. For example, trade provisions of certain environmental agreements takes precedence over NAFTA, subject to a requirement to minimize inconsistencies with the Agreement.

The word "transparency" is used throughout NAFTA literature. Transparency refers to regulatory and enforcement processes that are open, follow clear procedures and allow for observers to see "transparently" – what is really going on. This is a major value in the World Trade Organization and NAFTA agreements, since many countries have administrative processes that are opaque and arbitrary.

In Chapter 2, Background -- reference is made to the "injury test". This comes under the Antidumping and Countervailing Duties (ADD/CVD), Chapter 19 of the NAFTA. This section applies to importers who enter into agreements to purchase products overseas for importation into the United States. They should check to see if that product is subject to antidumping or countervailing duty order by the Department of Commerce. If goods should come under this order, the amount of customs duties could be great. Antidumping duties are taxes assessed on imported goods that are sold in the United States at a price less than fair market value. Fair market value is determined as the price the product is normally sold at the manufacturer's domestic market. Countervailing duties are taxes assessed to counter the effects of subsidies provided by foreign governments to goods exported to the United States. Subsidies cause the price of such merchandise to become artificially low, which may cause economic "injury" to US manufacturers. I am not an economist or a trade expert, but Mr. Jeffery Schott, from the

Institute for International Economics is and in a telephone conversation was nice to walk me through this definition.

An Administration Update published by the Government Printing Office, 1999 states, "The US bilateral trade balance with Mexico did shift from a surplus of $1.4 billion in 1994 to a deficit of $15.8 billion in 1995 (remaining at $15.7 billion through 1998). A bilateral trade deficit may signal cause for concern, but it is important to distinguish between bilateral and global deficits, deficits arising from unfair trading practices, and deficits cause by market fluctuations. The shift in our bilateral balance of trade with Mexico is the latter, and reflects the confluence of two events. First, Mexico's balance-of-payments crisis and its deep recession in 1994-95 reduced Mexico's ability to import. Second, strong sustained growth in the US economy increased our demand for goods, including imported goods. Even with a bilateral deficit, the US economy is enjoying its best economic performance -- unemployment dropped to 4.3 percent" (34).

In Chapter 5, I have provided an analysis of the contemporary economies of each country. The most important advantage of the United States is not only its size but also its easy access to Canada and Mexico. The United States also has the highest per capita GDP and the highest employment/population ratio. Mexico has only 9 percent of the total GDP and Canada only 8 percent.

The most banal analysis that can be made about NAFTA is that five years is too short a time to determine its success or failure especially since only three years of data has been collected due to three exogenous events that complicated current data. A prolonged recession in Canada, a severe monetary crisis in Mexico, and an unusually long and strong recovery in the United States have affected trilateral trade. Difficulties in Canada and Mexico have tended to reduce their imports, whereas US growth and a strong dollar have encouraged its imports. In addition, total employment growth in the United States has done away with any negative employment effects that NAFTA might have generated.

CHAPTER II

BACKGROUND TO THE NORTH AMERICAN FREE TRADE AGREEMENT

Introduction

On June 11, 1990, United States (US) President George Bush and Mexican President Carlos Salinas de Gortari agreed to pursue the negotiation of a free trade agreement, or FTA, between their two countries. The NAFTA negotiations represented a further step in a gradual process of economic integration that has been under way implicitly in North America for quite some time. Between 1985 and 1989, the US and Mexico signed three major accords:

- The Understanding of Subsidies and Countervailing Duties (1985) was in essence a surrogate for Mexican participation in the subsidies code of the General Agreement on Tariffs and Trade (GATT). Mexico agreed to undertake reforms of its subsidy programs in exchange for an agreement by the United States to apply an injury test in countervailing duty cases involving Mexican products.
- The Framework of Principles and Procedures for Consultation Regarding Trade and Investment Relations (1987) established a

consultative and dispute settlement mechanism for bilateral trade problems and an "immediate action agenda" for negotiations on bilateral trade and investment issues in goods and services sectors; these negotiations resulted *inter alia* in sectoral accords on steel and textiles.

- The Understanding Regarding Trade and Investment Facilitation Talks (1989) initiated a bilateral round of negotiations on a broad range of issues, including difficult intellectual property questions (Hufbauer, Schott: 1992, 3-4).

In addition, a third trading partner fits into the equation between the US and Mexico -- Canada. It is not my intention to analyze US-Canada issues, except where NAFTA modifies or augments FTA provisions, or to explain the relationship among the three countries to NAFTA. As a matter of fact, the more important accord has been the Canada-US FTA, which set many useful precedents for the NAFTA. In March 1990 Canada and Mexico signed 10 separate accords to improve bilateral consultations and data sharing on issues ranging from agricultural trade to environmental cooperation to such non-trade areas as extradition and drugs. The package also included the Framework for Trade and Investment (Hufbauer, Schott: 1992, 4).

Closer integration of the American, Canadian, and Mexican economies could yield a market as large and populous as the European Community (EC) and the European Free Trade Association (EFTA) combined: in 1989 the EC and EFTA countries had a combined GNP of $5,784 billion and a population of 358 million, compared with the combined Canada-Mexico-US GNP of $5,932 billion and a population of 357 million. Of course, the North American region is dominated by the US economy, which accounts for more than 85 percent of the regional output and nearly 70 percent of its population. By comparison, the largest single member of the European groups, the (unified) German economy, accounted for only 25 percent of combined EC-EFTA GNP in 1989, and 22 percent of the combined population. The appeal of a North American economic alliance is *not* that it would greatly embellish the existing trading "bloc" known as the United States, but rather that it holds open the prospect for substantial synergy among the three economies that could generate important income and employment gains and enhance the international competitiveness of firms throughout the region (Hufbauer, Schott: 1992, 4).

The last point is particularly important. All three countries run large current account deficits, have accumulated large foreign debts, and consequently need to pursue an export-led growth strategy. Clearly, each country cannot solve its problems on the backs of its neighbors; all three countries need to improve the efficiency and productivity of their labor forces and industries to compete more effectively against foreign suppliers in markets at home and abroad. This is the most important objective of the NAFTA.

Moreover, the three economies were linked closely before NAFTA by an extensive network of trade and investments, which makes the task of further negotiations easier. Both Canada and Mexico conduct between two thirds and three quarters of their trade with the United States, and the United States conducts about one quarter of its trade with the two of them combined. The combined intraregional trade of the three countries represents about 40 percent of the exports of the EC member countries (Schott 1991). In addition, both Canada and Mexico host substantial US direct investment, while the United States benefits from substantial Canadian direct investment and hosts large sums of Mexican portfolio and real estate investment (much of which represents flight capital). The NAFTA reforms would further expand the trade and investment linkages among firms in the region (Hufbauer, Schott:1992, 4-6).

Economic policies in the three countries are propelling closer economic integration, driven by common interests in deregulation and privatization on the domestic front, and common needs to deal with large current account deficits on the external front. A NAFTA would reinforce those existing trends. However, it would not result in the degree of deep integration already seen in the European Community. The implications of the prospective pact are significant, but they fall short of a common market (Hufbauer, Schott: 1992, 6).

No one can predict the precise course of NAFTA with other emerging markets, but for now NAFTA US-Mexico-Canada trade will continue to deepen because of NAFTA's limited objectives (efficient production, regional marketing, unencumbered investment, swift resolution of disputes, greater protection of intellectual property and many other advantages). The US is affected by monetary and fiscal policy in Canada and Mexico, as is evident from Mexico's financial crisis and the low level of the Canadian dollar with respect to the US dollar, but much less than the reverse. For the most part, the United States can pursue its own macroeconomic policy with only scant regard for what is being done in the other two countries, whereas they cannot ignore US policy.

Mexico

Whatever else Carlos Salinas may have been, he was a true believer in an open capitalist economy for Mexico. Salinas made the first move toward NAFTA[1], and in June 1990—shortly after the Canada – United States Free Trade Agreement (CUSFTA) took effect—Presidents Salinas and Bush issued a joint statement endorsing a US– Mexico free trade agreement.

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[1] This was after he traveled to Europe in search of investors and found West Europeans preoccupied with the newly opened Eastern Europe.

Salinas then sold the idea to a majority of his countrymen. How did he do it? He presented NAFTA less as a means to open markets to Mexican exports than as a means to access almost-limitless foreign capital. He had already prepared the way for the agreement by reducing tariffs and eliminating laws against foreign ownership of Mexican companies. But with Mexico's still-huge foreign debt and its underdeveloped economy, massive foreign investment was desperately needed. NAFTA would give investors the confidence to go ahead. The agreement would also provide a measure of prestige to Mexico and to Salinas himself. Formal association with the United States and Canada would give Mexico special status, especially compared to its Latin American neighbors.

Salinas persuaded his country to abandon more than 50 years of protectionist policies and fear of *el coloso del norte,* to embrace openness and enter virtual economic union with the United States. He agreed that Mexico would eliminate tariffs and other barriers to trade, permit foreigners to hold majority ownership of Mexican companies, open the banking system to foreign banks, and renounce expropriation of foreign assets without just compensation. It was, perhaps, one of the more significant national policy reversals in history (Cremeans: 1998, 4).

United States

Of the three leaders, George Bush had the least individual stake in the negotiations (Brian Mulroney, Prime Minister of Canada was the second). His popularity was at its height following Desert Storm, and there was no pressing need to open trade with Mexico.[2] There seemed to be advantages – NAFTA explicitly gave greater security for American investors, particularly in Mexico: the agreement committed Mexico both to opening previously closed industries to foreign investment and to forswearing the expropriation of foreign assets. More importantly, NAFTA seemed a sure way of securing privileged access to the Mexican market of 93 million potential consumers, and Mexico's economic growth of 3.9 and 4.0 percent in 1990 and 1991 suggested that the Mexican economy was poised for dramatic improvement.

Another factor was that an independent, strong, and economically healthy Mexico is a fundamental US interest.[3] Salinas was committed to NAFTA, and the US Government wanted to support a progressive and successful Latin American leader. Moreover, a thriving Mexican economy seemed the best and most desirable way to curb illegal immigration. The agreement was signed, but its approval became one of the issues in the 1992 election.

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[2] The average Mexican tariff on US imports was about 12 percent (U.S. tariffs on Mexican goods, about 4 percent), and imports from the United States were almost 70 percent of the Mexican total.

[3] For example, the "Enterprise for the Americas Initiative," proposed by George Bush in 1989, included all the Americas, but encompassed the idea that free trade in the Latin American countries would increase stability and represent a gain for the United States.

As a presidential candidate, Bill Clinton said he was for NAFTA in principle, but that there were inadequate protections against environmental abuses and that American labor was not protected against sweatshops and other labor abuses. He said he would correct it by making "side agreements" with Canada and Mexico that would cover the flaws of the agreement negotiated by President Bush. Third party candidate Ross Perot made the now-famous comment that he could already hear "a giant sucking sound" as American jobs went south to Mexico (Cremeans: 1998, 4-5). What Perot envisioned was firms in the US closing their plants and moving to Mexico.

Despite attempts by Ross Perot to identify imports from low-wage countries as a major national problem, there has been no widespread political movements in America to do so. On the contrary, the Clinton Administration was able to get congressional approval for a large number of trade agreements encompassing Canada, Mexico, Europe, Japan and many other nations. In 1995, even as exports to Mexico slowed, the administration was citing polls showing that for the first time in memory, the majority of Americans thought trade was good for the economy (Garten: 1997, 43).

Nothing in NAFTA directly creates or destroys jobs. NAFTA is not a work program. It merely creates opportunities for trade, which generates economic growth, which generates jobs. Consequently, no easy method exists to calculate jobs created or lost.

CHAPTER III

Synopsis and Analysis of the North American Free Trade Agreement by Chapters

Given the sheer volume and complexity of the NAFTA Agreement, with over 1000 pages of operative text and roughly 2000 pages of annexes and technical materials, the following synopsis and analysis, by chapter offers a basic understanding to the objectives the Agreement seeks to achieve (NAFTA Volumns I and II, 1992).

Chapter 1 and 2 – Objectives and Definitions

In Chapters 1 and 2, Objectives and Definitions, the three parties formally established a free trade area (FTA) by eliminating barriers to trade in goods and services. The countries promised to:

- promote "conditions of fair competition" within the FTA;
- increase investment opportunities within the FTA;
- effectively protect and enforce intellectual property rights;
- create a framework for further cooperation to enhance the benefits of the Agreement.

Relationship to other treaties:

- GATT. The signatories, each of which is a member of the General Agreement on Tariffs and Trade (GATT), agreed that the

NAFTA provisions would prevail in the event of conflict with their prior obligations to each other under the GATT. They otherwise confirmed that GATT would continue to govern trade between the NAFTA Parties.

- Environmental Agreements. Specified agreements dealt with endangered species, ozone depletion, hazardous waste movement and disposal, along the US - Mexican border (See Environmental Regulation Chapter) (Paul, Hastings, Janofsky & Walker: 1992, 3-4).

Chapter 3 – Tariff Elimination and Market Access

Tariff Elimination and Market Access accomplishes NAFTA's central objective for trade in goods between the US and Mexico: the elimination of import duties on goods that originate within North America. Duties were removed in 1994 on key categories of goods, including computers and most automobiles. Duties on other products will be phased out over 5, 10, and 15 year intervals. The duty-reduction regime put in place between Canada and the US by the 1988 CFTA will continue as scheduled until completion in 1999. This chapter also discussed the removal of non-tariff restrictions such as import licenses and quotas, although existing restrictions were grandfathered in several key industries (including automotive and textiles). Because Mexico has broadly and unilaterally eliminated most of its import licensing system, this provision will have fewer dramatic effects than the duty phase-outs, which will affect all three North American markets.

National Treatment. The Agreement confirmed that each signatory will confer national treatment to the goods of the other Parties. "National treatment" means treatment at least equal to that accorded similar domestically-produced goods. The exceptions centered on certain preferential tax and rate preferences in Canada for Canadian goods, on liquor and spirits, and technical items. This added little new, since each of the countries is already bound to afford national treatment to imports from the others under GATT.

Tariff Elimination. The Agreement provided that import duties will be eliminated according to a schedule that places each tariff category in one of four stages:

A - Immediate elimination

- duty free as of the effective date of NAFTA (January 1, 1994)

B - 5 year phase out

- duty-free as of 1998

C - 10 year phase out

- duty-free as of 2003

C+ - 15 year phase out

- duty-free as of 2008

Over half the US tariff categories will fall under the staging category A, thus eliminating duties immediately. The C and C+

categories are populated and import-sensitive items, particularly in industries in which all three countries have substantial domestic industries to protect (such as steel).

Import Licenses and Quotas. The NAFTA Parties agreed in Article 309 to eliminate non-tariff import and export restrictions, most notably import licenses and quotas. A number of industries were broadly exempted from the provision, however, including autos and auto parts, agriculture, textiles and energy. In addition, Mexico was permitted to retain import licensing requirements for 10 years on a long list of important manufactured items, including computers and disk drives.

Export taxes. The parties agreed not to impose taxes on exported goods unless the goods were subjected to the same tax if consumed domestically.

Drawbacks and Waivers. Under NAFTA, duty drawback programs will be eliminated on Mexican-related trade by 2001.

This was among the most important NAFTA negotiating goals of the US and Canada, since Mexican drawback programs could be used to establish an export platform in Mexico for large Asian manufacturers. These programs would permit such manufacturers to recoup the import duties paid to Mexico on Asian components imported for incorporation into products to be produced for the US or Canadian markets. Mexico resisted full elimination of this drawback program, but was able to obtain only a deferral of the termination date to 2001.

Country of Origin Markings. The parties agreed in Annex 312 to develop a common set of rules to govern one of the most complicated areas of tariff practice, marking requirements to designate the country of origin of imported goods. The annex spelled out basic marking principles to be applied to North American goods. For the most part, these principles appeared to reflect established practices in marking for US customs purposes.

Customs User Fees. The user fees charged by Mexico (0.8 per cent of the value of the goods) and the US (0.17 per cent of the import value, up to a specific ceiling) were to be eliminated by mid-1999.

Key Points and Primary Impact

The elimination of Mexican duties on US and Canadian products will have a major impact on the competitiveness of those products within Mexico – considerably more significant than the impact of the elimination of US duties on Mexican products. Mexico's average tariff on imported goods is in the 10 per cent range, with tariffs in the auto sector of 20 per cent. Reduction of these tariffs to zero per cent will create highly attractive potential profit margins for US companies that can establish efficient distribution systems in Mexico.

Mexican manufacturing businesses were lukewarm about NAFTA from the start for the reason stated above. While overall employment is expected to grow in Mexico as a result of new plant investment designed to take advantage of NAFTA, much dislocation will occur in established industries that previously have enjoyed only limited competition for secure domestic Mexican systems in Mexico.

US tariffs on Mexican goods, by contrast, average 3.9 per cent (and only 2.5 per cent on autos). As a practical matter, eliminating these tariffs will not affect the incentives for Mexican companies to produce for the US market in most product areas.

Affected Industries

The Mexican maquiladora industry will be adversely affected by the tariff eliminations. That industry is premised in part on Mexico's special no-duty rule for components imported temporarily for assembly in border-area plants into finished products that would then be shipped to the US. Once NAFTA is implemented,

- no duties will apply to US-origin components shipped anywhere in Mexico for assembly or incorporation;
- components imported to Mexico from Japan or other non-NAFTA sources will no longer be eligible for duty drawback when the finished products are shipped to the US; mere assembly operations will not confer North American origin on the finished product in many instances, absent the addition of substantial Mexican or North American content. This leaves most of the established maquiladora industry with few advantages over other locations in Mexico. Yet, the Mexican trade association representing maquiladora companies,

Canacintra, predicts growth for the maquiladora industry under NAFTA (Paul, Hastings, Janofsky & Walker: 1992, 5-10).

Chapter 4 - Rules of Origin

Chapter 4 established the rules for determining which goods originate in North America, and are therefore eligible for duty-free treatment and other benefits under NAFTA. The negotiators adopted the same basic origin rule as has governed the 1988 Canada-US Free Trade Agreement (CFTA): goods generally must undergo sufficient processing within North America to result in a change in tariff classification. Special rules were adopted for automobiles and textiles that increased the percentage of North American components and manufacturing required in order to qualify for NAFTA origin.

Basic Origin Rules. NAFTA origin is available under Article 401 for goods that:

- are wholly NAFTA-produced. A good "wholly obtained or produced" in a NAFTA country, or produced in a NAFTA country "exclusively from [NAFTA]- originating materials," qualifies for NAFTA origin.
- incorporate non-NAFTA components if each such component undergoes a specific change in tariff classification "as a result of production occurring entirely" in a NAFTA country, or where

- the assembly of such parts and components within the NAFTA zone is sufficiently complex to account for 50 per cent of the net cost or 60 per cent of the value of the finished product or where
- the value of all non-NAFTA materials used in the production of the product no more than 7 per cent of the value of the good.

Tariff Classification Changes. The Parties provided in Annex 401.1 an extensive specification of the tariff changes required in order to confer North American origin on products produced in part from non-NAFTA components. For some products, a change from one major heading to another is required; for others, a change between sub-headings is sufficient.

The first stop for any company interested in determining how its products will be affected by NAFTA's duty reduction program is the tariff category listings on Annex 401.1. In most cases, this listing will indicate the operations required to meet the change-of-tariff test.

There is no minimum domestic content required for most products to qualify for NAFTA benefits. The determinative requirement is whether, after undergoing processing in the US, Mexico, or Canada, the product falls into a new tariff category as specified on Annex 401.1. The cost, complexity and investment required to achieve a tariff classification change will differ from product to product.

NAFTA differs from other preferential duty programs such as the Generalized System of Preferences (GSP) and the Caribbean Basin

Initiative, which require a specified percentage of value to be imparted in the country claiming the duty benefit (e.g., 35 per cent for GSP products).

It also differs from the US Customs standard for determining origin in product marking, quota compliance, or trade sanctions cases, under which origin is conferred on the country in which the last "substantial transformation" of the product occurred. In Customs practice, the presence of a tariff category change is not determinative; products may undergo a tariff change yet not be deemed substantially transformed.

The only reliable method for a manufacturer to determine whether a product will qualify for NAFTA origin is to review carefully the governing customs rulings on tariff classification for the tariff categories at issue, or to obtain an advance ruling under the procedures established in Chapter 5.

Regional Content Formula. Article 402 created two methods of calculating the regional (North American) content of a good:

- Transaction Value. Regional content is calculated by removing the price paid for non-NAFTA-origin materials used in the production of the good from the price actually charged for the finished good.
- Net Cost. Net cost is calculated by removing the price paid for non-NAFTA-origin materials from the net cost to the producer who produced the good. In arriving at the net cost, the

producer may exclude sales, marketing, servicing, royalty, shipping, and non-allowable interest costs.

The exporter or producer may elect the method to be used for each item.

Special Automobile Rules. Article 403 created special origin requirements for automotive goods claiming NAFTA benefits. Passenger autos, light trucks, and engines must contain NAFTA content, calculated on the net cost basis, of 56 per cent beginning in 1998 and 62.5 per cent beginning in 2002. (Other vehicles and parts must reach 55 per cent and 60 per cent levels on the same schedule.)

- For new plants built to produce autos of a new "class, marque, or size and underbody," the North American content requirement is reduced to 50 per cent for the first five years of production. For refitted plants producing a new class, marque, or size and underbody of car, the requirement is reduced to 50 per cent for two years.

Special Textile Rules. Textiles are governed by a separate annex to Chapter 4, which established a "yarn forward" requirement for most products. Under this test, textiles and clothing must be produced from yarn produced in a NAFTA country. Cotton products are subject to a "fiber forward" rule. Clothing and fabrics that do not qualify under these rules may nonetheless benefit from a reduced tariff rate under tariff rate quotas (TRQs) provided in the Agreement.

Key Points and Primary Impact

The most significant impact of the NAFTA origin rules will be felt in the auto sector, where the hurdle for duty-free treatment has been raised materially from the 1988 CFTA. In the CFTA, auto products could claim duty-free importation if the local content was 50 per cent. Some Japanese plants in the US and Canada may have difficulty achieving a 62.5 per cent North American cost ratio. (This may be true even though NAFTA will permit an allocation of sales and servicing cost to count as North American content).

NAFTA will reinforce the movement toward a multilateral standard for determining origin of goods. With the widespread adoption of the Harmonized System of Tariff Classification, which became effective in the US in 1989, it is now possible to develop a common test based on change in tariff classification, with individually negotiated variations to address specific industry concerns in bilateral trade settings. NAFTA adopts this approach, and in so doing will reduce the uncertainty that other origin standards – particularly the "substantial transformation" test used US Custom's practice – could have engenderd.

Affected Industries

Autos and auto parts, textiles and computers will be affected by significant changes in the rules of origin presently applicable. All other industries are affected, since the origin rules are common to determining eligibility for NAFTA benefits.

Primary Concern

A primary concern throughout the negotiations was to assure that Asian manufacturers could not gain the duty-free benefits of NAFTA without making significant investment in Mexico. The origin rule is the principal method of policing this "export platform" concern. Because it permits goods to claim Mexican origin at the point of tariff category change, NAFTA will make new plant investment within the US less important to the cost reduction and political insulation objectives of Japanese manufacturers who rely on the US market (Paul, Hastings, Janofsky & Walker: 1992, 11-16).

Chapter 5 - Customs Procedures

Chapter 5 provided safeguards for ensuring that only goods satisfying the NAFTA Rules of Origin are accorded preferential tariff treatment. These included origin verifications and advance rulings. In addition, Chapter 5 provided for record keeping requirements and cooperation between the Parties on customs-related matters. The record keeping burdens imposed by this chapter are so onerous that many importers will forego the benefit of duty-free or reduced-duty North American origin. Importers must retain records for five years permitting components to be traced to their ultimate origin and detailing production costs and assists incurred in North American manufacture. In some instances, cost of record keeping will outweigh the duty savings.

Certificate of Origin Requirement.

NAFTA requires a uniform certificate of origin be prepared by the exporter. This document certifies that a good being exported from one Party into the territory of another Party qualifies as an "originating good".

Certificates of Origin are not required for either commercial or noncommercial importation of goods whose value does not exceed $1,000 US. However, for commercial importations, a Party may require that the shipping invoice contain a statement certifying that the goods qualify as originating goods.

- Obligations Regarding Exportations. NAFTA provided that a false statement by an exporter in a Party's territory to the effect that a good to be exported to the territory of another Party qualifies as an originating good will have the same legal consequences as would apply to an importer in its territory with respect to making false statements. Where an exporter voluntarily corrects an erroneous Certificate of Origin, it shall not be subject to penalties with respect to making the erroneous certification.
- Obligations Regarding Importations. When claiming preferential tariff treatment for imported products, importers are required to declare that the product qualifies as an originating good. The importer must base this declaration on a valid Certificate of Origin. When an importer omits making a

justifiable claim for preferential tariff treatment, the importer may, within one year of the date of which the good was imported, apply for a refund of any excess duties paid as a result of the good not having been accorded preferential tariff treatment.

Product Tracing and Record Requirement.

NAFTA required that exporters and importers maintain records relating to Certificates of Origin for a period of five years. The records required to be maintained include those related to the purchase of, cost of, value of, and payment for the good that is exported and the materials used in the production of that good. The aim of these strenuous requirements is to facilitate verification of North American origin.

Origin Verifications.

The customs administration of each Party may verify whether a good imported into its territory qualifies as an originating good. This is done, in part, either by submitting written questionnaires to the exporter, or by visits to the premises of an exporter or producer in the territory of the exporting country.

NAFTA provides elaborate rules that effectively preclude surprise verification visits into other countries. For example, an exporter must give written consent to a verification visit. However, should an exporter or producer not give its written consent to a proposed verification visit by the customs administration of another Party, that Party may deny preferential tariff treatment to the good that would have been the subject of the verification visit.

Advance Rulings

Importers, exporters, and producers may obtain advance rulings on the origin of goods from the customs administration of the country into which the goods were to be imported. NAFTA requires that each party establish procedures for issuance of advance rulings, including a detailed description of the information required to process an application.

Customs Administrative Issues.

- Review and Appeal. NAFTA mandated that a Party give exporters and producers located in other Parties' territories substantially the same rights of review and appeal of its origin determinations and advance rulings as it provides to importers in its own territory.
- Uniform Regulations. NAFTA required that the Parties establish Uniform Regulations regarding the interpretation, application and administration of the Rules of Origin described in Chapter 4.
- Cooperation. Each Party is required to notify the other Parties of any determination of origin issued as a result of an origin verification, as well as any determination that is contrary to another Party's rulings. The Parties are also required to

cooperate in customs-related matters such as the collection and exchange of statistics and the harmonization of documentation used in trade.

- Working Group. NAFTA established a working group to address future modifications of the rules of origin and the uniform regulations.

Key Points and Primary Impact

The Chapter 5 procedures for advance ruling will aid in establishing certainty as to the actual state of origin by providing both for advance rulings on determinations of origin and for procedures for verification of certificates as to origin.

However, the document requirements will impose burdensome record keeping duties on companies required to verify that their goods contain the requisite North American content. Tracing of component and production stage costs is particularly difficult for small and medium-size businesses that normally do not maintain records in such detail. For products on which the import duties are low to begin with, the cost of additional record keeping may eliminate the savings realized from obtaining duty-free North American origin (Paul, Hastings, Janofsky & Walker: 1992, 17-20).

Chapter 6 – Energy

NAFTA's treatment of the energy sector is perhaps most significant. Pursuant to the restrictions in the Mexican Constitution that reserves to the Mexican State all ownership of Mexico's basic energy resources, NAFTA did not create significant new opportunities for private investment in oil, gas, refining, basic petrochemicals, or direct delivery of nuclear power or electricity. These activities remain controlled by the government-owned petroleum monopoly (PEMEX) and electric utility (CFE).

Notwithstanding this reservation, NAFTA still provided substantial new opportunities for private energy companies, particularly those in the electric power industry. Under NAFTA, foreign companies can acquire, establish and operate electric generation facilities in Mexico. Electricity generated at the facilities can be used at the site or the excess sold to CFE. Opening of the Mexican government procurement market will create opportunities for foreign companies to compete with Mexican entities for supply and service contracts with PEMEX and CFE.

NAFTA reserved to the Mexican States goods, activities and investments in the oil, gas, refining, basic petrochemicals, nuclear and electricity sectors. Consistent with Mexico's move to greater privatization of industries and resources, however, NAFTA opened many downstream activities in the energy sectors to greater private investment – both foreign and domestic. Among these liberalizations are:

- Private investment. NAFTA permits private companies of all three NAFTA Parties to own, invest in or operate
  - electric generation facilities for their "own use";

- cogeneration facilities (facilities that produce both electric power and useful thermal energy); and independent power production ("IPP") facilities that produce electricity for sale.

- Excess power not used by a privately-owned facility must be sold to Mexico's government-owned electricity monopoly (CFE) under terms agreed upon by the facility owner and CFE.
- Government procurement. Both CFE and PEMEX, Mexico's oil monopoly, will open up 50 per cent of their government procurement contracts to immediate competition from US and Canadian companies.
  - These contracts will be principally for equipment and related supplies, but could include provision of services as well.
  - During the transition period, the remainder of Mexican government contracts in the energy sector will be reserved for Mexican companies.
  - All restrictions on Mexican government procurement will be phased out over a period of 10 years:
    - After eight years, US and Canadian firms will be able to compete for 70 per cent of CFE and PEMEX contracts.
    - By the tenth year, all government procurement restrictions will be eliminated.
- Decentralization of supply contracts. To promote more cross-border trade in natural gas and basic petrochemical trade,

NAFTA provided that end-users and suppliers, as well as state enterprises as may be required under domestic law, will have rights to negotiate supply contracts. Such contracts may be subject to regulatory approval.

- Equal treatment for exports. NAFTA prohibited Parties from imposing any tax, duty or charge on the export of energy or basic petrochemical goods unless the same tax, duty or charge is imposed on domestic consumption of such goods.

Key Points and Primary Impact

Increased opportunities in the electric power sector. US utilities and IPPs, both facing competition for their power plants in the US, will not have an additional large, nearby market for their equipment, investment capital and operational expertise. NAFTA expands on Mexico's attempts in recent years to liberalize its laws on foreign ownership of cogeneration facilities. That liberalization has been complicated, however, by murkiness in Mexican law as to what restrictions would apply to foreign ownership. Mexican lawmakers can be expected to clarify these laws in enacting legislation to implement NAFTA's energy provisions.

Mexico's demand for electricity is increasing almost 5 per cent annually, and it will need 26, 000 MW of capacity by the year 2000. However, Mexico lacks the capital to build the needed generation facilities. NAFTA's energy chapter was in part designed to meet this need by providing enhanced private investment opportunities in the Mexican energy sector.

NAFTA also expanded on Mexico's current Build-Lease-Transfer (BLT) program that permits foreign companies to build a facility while leasing the site during construction and then to transfer the plant back to the government shortly before commercial operation. With the implementation of NAFTA, foreign companies will be able to own the plants and earn profits on sales of power back to CFE for the life of the facility.

Increased Opportunities to Compete for Mexican Government Contracts in the Oil and Gas Sector

Ownership of basic petrochemical resources in Mexico will remain reserved to the Mexican government under its Constitution. However, the opening of the government procurement market will result in new opportunities for US drilling and oil field supply companies (see discussion in Chapter 10). In addition, NAFTA's gas provisions potentially enable US owners of gas-fired cogeneration facilities and other gas-fired facilities in Mexico to arrange for competitive gas supplies from US gas companies.

The internal PEMEX Debate. Genuinely open oil and gas markets were not created under NAFTA, and the effect of the Agreement's electricity provisions will depend greatly on how they are implemented. During the Salinas administration the core group of economic officials recognized the special protections PEMEX would enjoy under NAFTA. But the political sensitivity of these issues in Mexico caused them to tiptoe carefully around the PEMEX bureaucracy. However, the broad restructuring of PEMEX in1992 should make it easier to realize the market opening potential of NAFTA for IPPs, project developers, advanced petrochemical producers, and other industries (Paul, Hastings, Janofsky & Walker: 1992, 21-25).

Chapter 7- Agriculture

This chapter dealt with trade in agricultural goods and sanitary and phytosanitary measures, with the objective of:

- eliminating non-tariff barriers to agricultural trade;
- eliminating many tariff barriers immediately and phasing out all tariff barriers over a ten year period (15 years for certain highly sensitive products);
- encouraging the NAFTA countries to eliminate export subsidies and to limit domestic support measures to those which do not distort trade;
- ensuring common application of agricultural classification, grading or marketing standards;
- avoiding trade barriers resulting from sanitary or phytosanitary measures which are not based on scientific principles, are unfairly applied or are not necessary to provide a country's chosen level of protection.

The elimination of tariffs and non-tariff barriers will have a major impact on agricultural trade between the US and Mexico. Most commodities will become duty-free immediately with most remaining items becoming duty free over a ten year phase out period. These provisions are very specific and likely will not be susceptible to misinterpretation or manipulation. However, questions remain about enforcing rules regarding the origin of agricultural goods and about identifying and eliminating trade distorting export subsidies and domestic supports. The NAFTA countries recognized that export subsidies may have serious prejudicial effects on both importing and exporting countries and are inappropriate within the free trade area, except when used to counter subsidized imports from a non-NAFTA country. The United States and Mexico agreed that where either adopted or maintained a measure regarding the classification, grading or marketing of a domestic agricultural good, it will accord no less favorable treatment to similar goods imported from the other country for processing.

Chapter 7 is divided into two parts. Subchapter A deals with cross border trade in agricultural goods; subchapter B deals with sanitary and phytosanitary measures that may affect trade.

Market Access. NAFTA provided separate bilateral agreements on trade in agricultural goods, one between the US and Mexico and the other between Canada and Mexico. The trade relationship between the

US and Canada will remain subject to the Canada-United States Free Trade Agreement (CUSFTA) entered into in 1988, although certain provisions of Chapter 7, including those concerning domestic support measures and export subsidies, apply to all three countries.

Tariff and Non-Tariff Barriers. All agricultural non-tariff barriers between the US and Mexico will be eliminated immediately, generally through conversion to ordinary tariffs or to tariff-rate quotas under which a tariff kicks in only if imports exceed a given quota for the year.

Tariffs were eliminated immediately on a broad range of agricultural products so that, when NAFTA went into effect, approximately one-half of US – Mexico agricultural trade would be duty-free. Remaining tariffs are subject to phase-out over 10 years in most cases and 15 years in the case of highly sensitive products, such as corn and dry beans for Mexico and orange juice and sugar for the US. Tariff rate quotas will be phased-out, again over 10 or 15 year periods, by both increasing the yearly quotas, as well as decreasing the tariffs. All protection provided for so-called Section 22 commodities under the US Agricultural Adjustment Act of 1933 will be eliminated for Mexican agricultural goods.

Trade in sugar and sugar products between Mexico and the US is subject to special provisions regarding quotas and tariffs based, in part, on whether either country is a net surplus producer of sugar. As with other agricultural restrictions, all restrictions on trade in sugar will be eliminated in 15 years.

Domestic Support. The NAFTA countries recognized that domestic support measures can be of crucial importance to their agricultural sectors but may also have trade distorting effects. Accordingly, the NAFTA provided that each country should endeavor to move toward domestic support policies that have minimal trade distortion effects or which are exempt from any domestic support reduction commitments under the GATT. The countries agreed that any of them may change a domestic support mechanism at its discretion, provided that such a change does not violate that country's obligations under the GATT.

Export Subsidies. The NAFTA countries recognized that export subsidiaries may have serious prejudicial effects on both importing and exporting countries and are inappropriate within the free trade area, except when used to counter subsidized imports from a non-NAFTA country. NAFTA provided that:

- A NAFTA exporting country must give three days notice of its proposal to introduce an export subsidiary for exports to another NAFTA country and, upon request, must consult with that country;
- When a NAFTA exporting country considers that a non-NAFTA country is subsidizing the export of goods to another NAFTA country, the NAFTA exporting country may request

consultations with the NAFTA importing country with a view toward countering the effects of the subsidy:

- If the NAFTA importing country adopts measures to counter a third country subsidy, the NAFTA exporting country will not introduce its own subsidy; and;
- Each NAFTA country retains its rights to apply countervailing duties to subsidized imports from any source.

Agricultural Grading and Marketing Standards. The United States and Mexico agreed that where either adopts or maintains a measure regarding the classification, grading or marketing of a domestic agricultural good, it will accord no less favorable treatment to similar goods imported from the other country for processing.

Sanitary and Phytosanitary Measures. NAFTA recognized that each country may adopt, maintain or apply any sanitary or phytosanitary measures necessary for the protection of human, animal or plant life or health in its country, even if the measure is tougher than an international standard. However, each country agreed such measure should be:

- based on scientific principles and a risk assessment;
- applied only to the extent necessary to provide the country's chosen level of protection; and
- applied in a non-discriminatory manner to similar goods or conditions of a NAFTA exporting country.

NAFTA encouraged the countries to use established international standards where possible or adopt equivalent standards. The Agreement also established certain control, inspection and approval procedures with respect to sanitary and phytosanitary measures, as well as procedures to ensure "transparency" with respect to the nature of and reasons for such measures.

Key Point and Primary Impact

The NAFTA will create duty free trade in agricultural goods between the US and Mexico. This is expected to result in a significant increase in trade in both directions.

Affected Industries

All agricultural producers and processors, as well as related industries, will feel the impact of NAFTA. In the US, grain producers would be the biggest beneficiaries, while producers of fruits and vegetables, particularly winter crops, may be the most adversely affected.

In key areas, the NAFTA is not a trilateral agreement. The interplay between the different rules affecting US – Mexico trade, Mexico-Canada trade and US – Canada trade could result in significant imbalances in the free trade region (Paul, Hastings, Janofsky & Walker: 1992, 26-30).

Chapter 8 – Emergency Action (Safeguards)

The Emergency Action chapter of NAFTA established the ground rules for when a Party seeks temporarily to halt tariff reductions to protect an industry that is being seriously injured by surges in imports resulting from the reductions.

When a Party seeks to take bilateral emergency action against the imports of another Party, it must proceed according to the specific procedures and limitations set forth in Article 801. When a Party seeks to take multilateral (i.e., global) emergency action under "escape clause" procedures prescribed by the General Agreement on Tariffs and Trade (GATT), NAFTA requires that the goods originating from other Parties be excluded from the global action, unless those goods contribute substantially to the import injury. A Party against whom emergency action is taken is entitled to compensation for any adverse tariff treatment imposed by the acting Party.

While safeguard actions under the GATT rules have been used sparingly in US trade practice, this section could be of unexpected significance if the advertised benefits of NAFTA to US manufacturers – markedly increased access to the Mexican market as a result of tariff reductions and removal of non-tariff barriers – actually come to fruition. Mexican producers confronted with rapidly increasing market penetration from new US competition can be expected to press the Mexican government for emergency relief under Chapter 8. Mexico, as a recent GATT entrant, has a minimal track record in this area. How it handles such petitions will have a significant effect on perceptions of NAFTA's effectiveness in the trade community.

Chapter 8 divided emergency actions into two categories: Bilateral Actions, in which one NAFTA Party seeks safeguards against the imports of another Party, and Global Actions, in which a Party seeks protection under the GATT escape clause against imports of the subject merchandise from all countries.

Bilateral Actions. NAFTA provisions governing bilateral safeguard actions are spelled out in Article 801. They include:

- A Party may initiate a bilateral safeguard action only during the NAFTA tariff reduction transition period, unless it obtains the consent of the affected Party.
- The injury for which the safeguard is taken must have been caused by the reduction or elimination of duties under the NAFTA.
- An Action may be taken only once against any particular good, and may be maintained for a maximum period of three years (one additional year is permitted for specified extremely sensitive goods). No action may be maintained beyond the expiration of the transition period without the consent of the affected Party.
- The safeguard may take the form of either:
    - a temporary suspension of further reductions in the duty rate for the good under the NAFTA, or

- an increase in the duty rate not to exceed the lesser of (i) the Party's most favored nation (MFN) rate for the good in effect at the time the action is taken, or (ii) the MFN rate in effect prior to the effective date of the NAFTA.

- When the safeguard terminates, the duty rate on the affected good will be the NAFTA rate that would have been in effect one year after the date the action was commenced.
- On January 1 of the year after the action terminates, at the option of the acting party:
    - the duty for the good will be set at the rate established in the NAFTA Tariff Schedule; or
    - the tariff will be eliminated in equal annual stages ending on the date for tariff elimination established in the NAFTA Tariff Schedule.

Global Actions. NAFTA carved out the new free trade area from the effects of global escape clause actions taken under GATT by NAFTA signatories. A Party initiating a GATT escape clause proceeding must exclude imports from the other NAFTA Parties for the action, unless:

- the imports from a Party account for a substantial share of total imports, and
- the imports from that Party, considered individually, contribute importantly to the serious injury, or threat of serious injury, caused by imports of the subject merchandise. Imports from

Parties can be considered collectively to assess their impact on injury only in "exceptional circumstances".

NAFTA elaborated the rules for determining if these criteria are present and established restrictions to govern cases in which Parties are included:

- Imports from a Party cannot be considered to account for a substantial share of total imports if the Party is not among the top five suppliers of the merchandise by import share during the most recent three-year period.
- Imports from a Party normally cannot be deemed to "contribute importantly" to serious injury if the growth rate of imports from that Party during the time of the import surge is appreciably lower than the growth rate of total imports from all sources during that period.
- No global action can be taken against a Party that has the effect of reducing imports of the good from that Party below the recent trend of imports from the Party measured over a representative base period and allowing for reasonable growth.
- The Party taking emergency action must provide the Party or Parties against whose goods the action is taken mutually agreed compensation in the form of trade concessions (i) having "substantially equivalent trade effects" or (ii) equivalent to the

value of the additional duties expected to result from the emergency action.

Key Points and Primary Impact

As the "safety valve" for companies harmed by increased imports resulting from NAFTA's market-opening measures, safeguard proceedings could provide the relief of first resort for a number of the most import-sensitive industries. NAFTA's impact is likely to be greatest on those industries that currently enjoy the benefits of high tariffs.

Considerable effort appears to have been expended to develop a framework in the NAFTA – using the Canada-US FTA as a model – that would permit affected industries to petition for relief without undoing the tariff reduction measures that the Agreement aims to achieve (Paul, Hastings, Janofsky & Walker: 1992, 31-36).

Chapter 9 – Technical Standards

Chapter 9 addressed technical standards, a traditional non-tariff barrier to trade. Consistent with the ongoing GATT negotiations on this subject, the Parties agreed not to use standards-related measures as obstacles to trade.

NAFTA affirmed that each Party maintains the right to adopt, apply, and enforce standards-related measures, and to choose the level of protection it wishes to achieve.

<u>Compatibility.</u> NAFTA required the Parties to work together to enhance the level of safety and protection of human, animal and wildlife,

the environment and consumers. To this end, the Parties are required "to the greatest extent practicable" to make compatible their respective technical standard measures.

To accomplish this goal, each importing Party is required to treat technical standards adopted by an exporting Party as equivalent to its own where it is demonstrated that the exporting Party's technical standard adequately fulfills the importing Party's legitimate objectives.

Technical Cooperation. NAFTA encouraged cooperation between the Parties' standardizing bodies.

Procedural Transparency. NAFTA required public notice to all Parties prior to the adoption or modification of technical standards. This notice must identify the goods or services to be covered and the reasons for and objectives of the measure. All Parties and anybody interested in a particular proposed technical standard will be allowed to comment on it. To facilitate these comments, each Party must designate "inquiry points" to respond to questions and to provide information regarding technical standards or measures.

The above notice requirements do not apply where a Party deems a new technical standard necessary to address an urgent problem relating to safety. However, upon implementing an emergency regulation, the Party must provide to the other Parties a notification of the new regulation and permit the Parties and other interested persons to comment.

Risk Assessment. So long as a Party is not attempting to create an unnecessary obstacle to trade, it may conduct a risk assessment of goods and services to be imported into the country. In conducting risk assessments, NAFTA requires that the Party avoid arbitrary or unjustifiable distinctions between similar goods or services in the level of protection it considers appropriate.

Conformity Assessment. A conformity assessment procedure is used to determine that a technical regulation is followed. Each Party is required to recognize other Parties' conformity assessment bodies on the same basis that they accredit or otherwise recognize their own. In addition, each Party must give "sympathetic consideration" to another Party's request to negotiate agreements for the mutual recognition of the results of the Parties' conformity assessments.

International Standards. The Parties are theoretically required to base their technical standards on international standards. However, there is an Article 905(3) which provides that any NAFTA country may adopt technical standards that provide a higher level of protection than would be achieved if based on international standards.

Committee on Standards-Related Measures. NAFTA created a Committee on Standards-Related Measures whose duties in part are to: (1) facilitate the process by which the Parties make compatible their standards-related measures; (2) enhance cooperation on the development of standards-related measures; and (3) to otherwise monitor the implementation and administration of the technical standards section of the agreement. The Committee may create subcommittees and working groups to deal with specific topics of interest. Furthermore, those subcommittees and working groups may invite the participation of scientists and representatives of interested non-governmental organizations from each of the Parties.

Key Point and Primary Impact

Perhaps the primary impact of these provisions is to inject transparency into each Party's standards-setting procedures. By providing for full notice and opportunity to comment, NAFTA makes less likely the arbitrary setting of technical standards, and concomitant necessary obstacles to trade (Paul, Hastings, Janofsky & Walker: 1992, 37-39)

Chapter 10 – Government Procurement

The government procurement chapter imposed requirements of openness, transparency, and competitive bidding to procurement activity of federal government agencies and government-owned enterprises. It established detailed rules that each Party must implement in conducting procurements and in reviewing protests by disappointed bidders from other NAFTA countries. Most notably, these rules will apply to purchases made by Mexico's two dominant state energy enterprises, Petroleos Mexicanos (PEMEX) and the Comision Federal de Electricidad (CFE), whose procurement histories have favored Mexican suppliers.

Non-discrimination and National Treatment

NAFTA required that, in procurements covered by the Agreement, each Party must:

- Afford goods or services from other Parties the same treatment it affords goods and services of its own domestic producers.
- Treat local subsidiaries of other Party companies the same as it treats domestic suppliers

Article 1004 clarified that NAFTA Parties cannot discriminate against local subsidiaries offering goods that originate in a NAFTA country. No violation would occur, for example, if a Mexican agency refused to buy from a US subsidiary in Mexico offering a product manufactured in its Asian plant (unless Mexican suppliers were permitted to supply Asian goods).

Covered Procurements - Federal vs. State Purchases

The Agreement covered procurement by federal government entities in the three signatories. Procurement by state agencies (and provincial entities in Canada) were not covered.

- The Parties will "endeavor to consult" with state and provincial governments at some point during the Agreement's first five years, "with a view to obtaining commitments, on a voluntary and reciprocal basis" from the states to be bound by Chapter 10's procurement disciplines.

- The US preferences for small and minority-owned businesses were excepted. Federal agencies may continue to prefer such bidders over Mexican and Canadian suppliers.

Arguing for coverage of state procurement was an important negotiating element for Mexico. Neither the US nor the Canadian government was in a position, politically or legally, to commit state or provincial governments to non-discrimination rules.

Contract Thresholds

The Chapter 10 rules apply only to contracts exceeding specified thresholds:

- For federal agencies, $50,000 for goods or services ($6.5 million for construction contracts)
- For government enterprises (including PEMEX and CFE), $250,000 for goods or services ($8 million for construction contracts)

These thresholds will escalate according to the US inflation rate.

Government Enterprises

The procurement rules established by Chapter 10 apply fully to government-owned enterprises listed in Annex 1002.3. The Chapter's most striking achievement is the full inclusion of PEMEX, CFE and other Mexican enterprises on the Annex list. The Annex lists 37 Mexican entities, including the national postal, railroad, water, and port authorities.

PEMEX and CFE each may reserve, for Mexican bidders only, 50 per cent of its total 1994 procurement. This reservation will be stepped down every other year until it reaches 30 per cent in 2001. As of 2003, no portion of covered PEMEX or CFE procurement can be reserved for Mexican bidders. These reservations may not be concentrated in particular products. The Agreement provides that no more than 10 per cent of each year's reserved procurement can fall within each product supply classification.

Covered US government enterprises are limited to the Tennessee Valley Authority, the Bonneville and other power marketing administrations, and the St. Lawrence Seaway Development Corporation.

Services Contracts Covered

The Agreement covered all services contracts, other than those expressly excluded for each signatory. The exception for Mexico and Canada are broader than those available to the US.

All three countries exclude from coverage transportation, public utility, and telecommunications services, and contracts for federally-funded research and development centers or government-sponsored research.

Mexico also excluded "all risk-sharing contracts by PEMEX" and contracts for "financial services." Canada excludes printing and publishing contracts, and contracts for "business services" (defined to include most legal and financial services).

Key Points and Primary Impact

- The procurement provisions will have the most noticeable effect in Mexico. While the US and Canadian federal procurement has been regularized through those countries' adherence to the GATT Procurement Code, Mexico has not been a signatory to that code. Its agencies will have to develop tendering and protest procedures.
- The inclusion of PEMEX, CFE and other government enterprises as covered entities will open significant new markets for US firms. The procedures mandated by Chapter 10 will result in across-the-board modernization of the purchasing practices of those enterprises. Even in the transition years (1994-2002) in which a portion of those entities' procurements can be set aside for buy-Mexican treatment, new product and price competition will be introduced in the other, non-reserved procurements. That competition can be expected to have an important impact on the purchasing habits of PEMEX and CFE.

Affected Industries

- <u>Oil field, pipeline, and capital equipment suppliers</u>. The need for modernization of the Mexican infrastructure is enormous. PEMEX alone will spend over $20 billion in the next five years to increase efficiency and to modernize. CFE must develop generating capacity to double the available electrical power as the Mexican economy and population expands. Suppliers to these industries stand to benefit measurably.

- Technical consulting firms. Coverage of services contracts should open procurement markets, particularly in Mexico and Canada, for consulting firms with specialized expertise in engineering, project development and other areas (Paul, Hastings, Janofsky & Walker: 1992, 40-47).

Chapter 11 – Investment and Investment Disputes

Chapter 11 established a forward-looking open investment regime that expanded on recent bilateral investment treaties the US has negotiated with non-NAFTA countries. Subchapter A provided that, with respect to investors of another Party or investments of such investors in the territory of the Party, whether existing at the date of entry into force of the NAFTA or made thereafter, the Parties shall extend:

- National Treatment
- Most Favored Nation Treatment
- Non-discriminatory Treatment (the better of National Treatment or Most Favored Nation Treatment)
- Treatment in accordance with international law
- Freedom from the imposition of performance requirements (e. g., export at a certain level or include so much of domestic content)

- Freedom to appoint to senior management positions individuals of any particular nationality
- Freedom to appoint a majority of the board of directors from among non-nationals of the Party in which the investment is located

Subchapter B provided an elaborate mechanism to settle disputes between a Party and an investor of another Party either through arbitration in accordance with the International Center for the Settlement of Investment Disputes Convention or the United Nations Commission on International Trade Law Arbitration Rules, or through litigation before the courts of the Party, at the election of the investor.

Open Investment Principles

Each party agreed to extend to investors of another Party and to the investments of such investors in its territory treatment in accord with the following:

- National Treatment – treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments. Such treatment accorded by a state or province of such Party must equal the most favorable treatment which such state or province accords investors and their investments of such Party.

- Most Favored Nation Treatment – treatment no less favorable from that accorded, in like circumstances, to investors of another Party, or of a non-Party.
- Non-Discriminatory Treatment – treatment equal to or better of National Treatment and Most Favored Nation Treatment.
- Minimum Standard Treatment – treatment in accordance with international law, including fair and equitable treatment and full protection and security.

Parties may not impose:

- Performance requirement – in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment, for example:

- to export at a given level
- to achieve a given level of domestic content
- to accord a preference to domestic goods and services, relate the volume or value of imports to the volume of value of export, or restrict sales of goods or services in its own territory. This limitation on performance requirements does not prevent a Party from conditioning the receipt of an advantage on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development in such Party's territory.

- National management requirements – A requirement that senior management positions be filled with nationals of the Party.
- Board nationality requirements – A requirement that more than a majority of the board of directors be of a particular nationality or residents in the territory of the Party.

Reservations and Exceptions

Each Party made reservations and exceptions to the above requirements under the NAFTA. The most prominent for Mexico and the United States are:

- **Mexico**
  - Key Industries. As generally required by the Mexican Constitution, the right of the Mexican state exclusively to develop, operate or perform the following sectors or activities:
    - Petroleum, other hydrocarbons and basic petrochemicals
    - Electricity
    - Nuclear power and treatment of radioactive minerals
    - Satellite communications
    - Telegraph services
    - Radio telegraph services
    - Postal services
    - Railroads
    - Issuance of bills and mining of coinage

    - Control, inspection and surveillance of maritime and inland ports
    - Control, inspection and surveillance of airports and heliports

- Land. Investment by foreigners (except as beneficiary of a Mexican trust) in real property within 50 kilometers of the coast or 100 kilometers of Mexico's border is prohibited.
- Acquisitions. The right to review the acquisition, whether directly or indirectly, of more than 49 per cent of a Mexican enterprise if the value of the gross assets of that enterprise exceed levels stepping up from US$25,000,000 initially to US$150,000,000 during the tenth and subsequent years following the NAFTA taking effect.
- Cable TV. Only Mexicans may construct and operate cable television systems; investors of another Party could invest up to 49 per cent in a cable television enterprise.
- Construction. During the first 5 years of the NAFTA, foreign investors may not own more than 49 per cent of a construction company; thereafter, foreigners may own 100 per cent of a construction company.
- Drilling Risks. Prior approval of the foreign investment commission is required for investors of another Party to own directly or indirectly more than 49 per cent of an enterprise involved in "non-risk sharing" service contracts for the drilling of petroleum and gas oils.

- Maritime. Prior approval is required for investors of another Party to own more than 49 per cent of Mexican enterprises performing fishing on the high seas.
    - Only Mexican nationals may obtain authorization from the fishing ministry for deep sea fishing.
    - Only Mexican nationals can operate a shipyard or own vessels registered and flagged as Mexican. Prior approval is required for investors of another Party to own directly or indirectly more than 49 per cent of an enterprise established in Mexico operating foreign flagged vessels providing international maritime transport services.
- Automobile. Investors of another Party may not own more than 49 per cent of a Mexican enterprise engaged in the auto parts industry, although under certain circumstances where the investor is not controlled by or affiliated with a manufacturer of motor vehicles, the investor may own 100 per cent of the Mexican enterprise manufacturing auto parts. Also, manufacturers of motor vehicles must maintain certain local content percentages.
- Maquiladoras. A requirement that maquiladoras may not sell to the Mexican market more than 50 per cent of the total value of its exports will be phased out over an eight year period.

- Mining. During the first five years after the NAFTA takes effect foreigners or investors of another Party may not own more than 49 per cent of a Mexican enterprise engaged in the extraction of minerals.
- Air Transportation. Investors of another Party may own directly or indirectly no more than 25 per cent of the voting interest in a Mexican enterprise providing commercial air services. The chairman and at least two-thirds of the board of directors and two-thirds of the managing officers of such enterprise must be Mexican nationals.
  - This provision tracks a similar requirement in the US Federal Aviation Act that limits foreign ownership of US air carriers.
- Ground Transportation. Concessions to provide bus and truck services within each state are accorded with preference going to natural persons born in such states.
  - During the first six years after NAFTA enters into effect, cross-border bus and truck service by investors of another party will be phased in, but bus and truck service between two points within Mexico shall be reserved to Mexicans.
  - Within ten years after the NAFTA enters into effect, foreign investors may own up to 100 per cent of an enterprise providing bus services, tourist services and truck services for the transportation of international cargo between points within the territory in Mexico.

- **United States**
  - A foreigner may not obtain a license to transfer, manufacture, produce, use or import any facilities that produce or use nuclear materials.
  - The Federal Aviation Administration must certify aircraft repair stations performing work on US registered aircraft.
  - A US air carrier must be under the actual control of US citizens; non-US citizens may own and control foreign air carriers that operate between US and foreign points.
  - Within six years after NAFTA has taken effect, the provision of specialty air services in the United States by investors from another party will no longer require special authorization.

Dispute Settlement Related to Investment

Subchapter B established a mechanism to settle investment disputes that assures due process before an impartial tribunal. An investor of a Party has an option to seek to resolve a claim against a Party for breach of any of the provisions of Subchapter A before the tribunals of the Party where the investment was made or to submit the claim to arbitration.

- Once an investor has selected his option and initiated his claim, the investor may not thereafter bring the same claim before the other dispute resolution body.

- The NAFTA provides that such claims have a three year statute of limitation measured from the date on which the investor first acquired or should have first acquired knowledge of the alleged breach and knowledge that the investor has incurred loss or damage.

Key Points and Primary Impact

One of the most fundamental concerns of foreign investors in any foreign country is to what extent the foreign investor will have access to a hearing with due process before an impartial tribunal should it have a claim against the country in which it is investing. In the past this concern has been exacerbated in Mexico because of Mexico's insistence that all foreign investors sign the "Calvo Clause" which effectively limits foreign investors in Mexico to the protection of National Treatment; they are prohibited from seeking assistance from their own government at the risk of forfeiting their investment. Furthermore, the only avenue for such claims to be made is presentation of the claim before the Mexican courts.

With the agreed-upon procedures provided by Chapter 11, NAFTA eliminates the effects of the Calvo Clause as to investors of the other Parties. Similarly, the NAFTA gives Mexican investors in the United States and Canada access to resolution of disputes with those other Parties before an international arbitral tribunal.

Affected Industries

Chapter 11 effectively applies to all industries except the financial services industry (the procedures and protection for which are governed by Chapter 15). Furthermore, Chapter 11 provided that should its provisions be in conflict with the provisions of any other chapter of the NAFTA, such other provisions shall govern (Paul, Hastings, Janofsky & Walker: 1992, 48-57).

Chapter 12 – Cross-Border Trade in Services

This chapter applies to measures adopted or maintained by NAFTA country relating to cross-border trade in services by service providers of another NAFTA country. NAFTA breaks new ground in extending free trade commitments to services. A significant part of the stalled GATT Uruguay Round talks would impose a services trade regime similar to this NAFTA chapter, but United States, Canada and Mexico have taken a major pioneering step.

Under the Agreement

- Each NAFTA country shall accord to service providers of another NAFTA country treatment no less favorable than that it accords to its own service providers or, if better, service providers of another country;
- Service providers shall not be required to maintain an office in or be a resident of a NAFTA country in order to provide cross-border services;

- However, the NAFTA countries can maintain existing restrictions on cross-border services if such restrictions are listed on an annex to the Agreement.

The countries have two years to come up with lists of state and provincial restrictions which they propose to maintain and all local restrictions may continue to be maintained. The reservation of restrictions on numerous key services sections will dampen the impact of this chapter.

National and Most Favored Nation Treatment

Each NAFTA country must treat service providers of the other NAFTA countries no less favorably than it treats its own service providers in like circumstances. The same principle applies to state or provincial measures. In addition, each NAFTA country must treat service providers of the other NAFTA countries no less favorably than it treats service providers of any other country in like circumstances.

Local Presence

A NAFTA country may not require a service provider of another NAFTA country to maintain an office or a residence in that country as a condition to providing a service.

Reservations

Having stated the general principles of free trade in services, the Agreement allows each NAFTA country to keep certain existing restrictions which do not conform with those principles. Federal, state and provincial measures must be listed; however, the state and provincial listings do not have to be completed for two years. All local measures may be maintained.

Quantitative Restrictions

Each NAFTA country must also list any quantitative restrictions on service providers, including those which limit the number of service providers or the operations of service providers in a particular sector.

Licensing and Certification

In order to ensure that licensing and certification measures do not constitute an unnecessary barrier to trade, the NAFTA countries agreed that any such measure should:

- Be based on objective and transparent criteria;
- Be no more burdensome than necessary to ensure the quality of a service; and
- Not constitute a restriction on the cross-border provision of a service.

Two years after implementation of the NAFTA, each NAFTA country will eliminate any citizenship or permanent residency requirements for the licensing or certification of professional service providers. Special provisions apply to measures affecting foreign legal consultants and the temporary licensing of foreign engineers.

Exclusions

The Services chapter did not apply government procurement, financial services and energy related services, which were addressed specifically in other chapters. Nor did it apply to subsidies and grants, which were governed by separate GATT rules. The chapter also did not affect most air services, basic telecommunications, social services and the maritime industry.

Key Point and Primary Impact

This chapter paved the way for extending multilateral GATT protections to services trade and industries.

Depending upon the countries' reservations of existing restrictions, this chapter should greatly increase the ability of North American service providers to conduct cross-border activities without discriminatory restrictions. This, in turn, may help provide a competitive edge for such service firms in the global market, since they may gain experience in cross-border operations under NAFTA prior to the adoption of a broad GATT services code.

Affected Industries

The industries most affected include construction, engineering, accounting, commercial education, health care management, advertising, environmental services, tourism, land transport, consulting and architecture (Paul, Hastings, Janofsky & Walker: 1992, 58-61).

Chapter 13 – Telecommunications

The telecommunications chapter:

- Governs access to, and use of, public telecommunications transport networks or services, including private networks;
- Establishes conditions for the provision of enhanced or value-added services;
- Imposes certain standards-related measures relating to attachment of terminal or other equipment to public telecommunications transport networks; and
- Eliminates all tariffs, duties and other trade barriers over the next 15 years.

Significant restrictions now exist that inhibit cross-border investment in telecommunications services, the provision of enhanced services such as voice mail or data links, and marketing of telecommunications equipment. The US currently has an annual telecommunications services deficit with Mexico. By eliminating many of these restrictions, the Agreement is expected to erase this deficit, and to open the $6 billion Mexican telecommunications market to US equipment, enhanced services and investment.

Subject to certain conditions, public telecommunications networks and services will be open in all three countries for purposes of: leasing private lines; attaching terminal equipment; interconnecting private circuits; performing switching, signaling and processing function; and using any desired operating protocols. Access and use will be required on reasonable and non-discriminatory terms and conditions. Telecommunications equipment is divided into three categories for purposes of tariff reduction over the next 15 years. For example, tariffs for PBS, fiber and cellular phones, which constitute over 80 per cent of the current US telecommunications export to Mexico, would be removed immediately and tariffs for central office switches would be removed within 5 years.

Key Points and Primary Impact

The Agreement will open the large, and currently restricted, Mexican telecommunications market to US companies for direct sales of US made equipment and services, and for equity investment in Mexican companies. It removed both tariff and non-tariff barriers that have prevented the full development of Mexican market by US interests. Currently, the balance of telecommunications trade between the US and Mexico favors Mexico, especially in the area of tariffs and network charges. With this Agreement, it is expected that the balance of trade will become more favorable to the United States.

NAFTA may accelerate the movement of low-technology manufacturing operations to Mexico (e.g., telephone, answering machine and fax terminal equipment). Production of such products has moved offshore dramatically over the last decade. For example, after the 1984 divestiture of the Bell System, AT&T shifted most of its manufacture operations overseas. AT&T now produces approximately nine million phones annually in Mexico, an increase of seven million since 1984.

Affected Industries

Manufacturers of telecommunications equipment and providers of telecommunications services. These include: equipment manufacturers; local exchange carriers; long distance providers; cellular service providers; cable television interests; personal communication service providers; and long distance resellers (Paul, Hastings, Janofsky & Walker: 1992, 62-66).

Chapter 14 – Financial Services

For the first time in 50 years Mexico will permit financial institutions in the United States and Canada to establish wholly owned Mexican subsidiaries to provide banking, insurance and securities services in Mexico.

The Agreement established a transition phase for each financial service sector to the year 2000. During that period:

- Mexico will gradually increase the aggregate foreign market share limit in banking from 8 per cent to 15 per cent
- The limit for securities activities by foreigners will increase from 10 per cent to 20 per cent
- No one foreign bank can have more than 1.5 per cent market share, nor a foreign securities dealer more than 4 per cent. (Following the transition, requests to allow bank acquisitions

will remain subject to scrutiny for "reasonable prudential considerations" and subject to an aggregate 4 per cent market share limit on the resulting institution.)

- US and Canadian insurance firms may own 100 per cent of Mexican insurance companies by the year 2000; however, making the investment through a joint venture with a Mexican insurer will avoid the aggregate and individual market share caps.
- US and Canadian finance companies may, on terms no less favorable than those accorded to Mexican institutions, establish separate subsidiaries in Mexico to provide consumer lending, commercial lending, mortgage lending or credit card services – provided that, during the transition period, the aggregate assets of such subsidiaries may not exceed 3 per cent of the sum of the aggregate assets of all banks in Mexico plus the aggregate assets of all types of such limited scope financial institutions in Mexico.

The NAFTA provided that negotiations to allow direct branching by banks throughout Canada, the US and Mexico will take place when the United States has modified its laws to permit interstate branching in the United States. Foreign banks operating in the United States through a US banking subsidiary may utilize that subsidiary to benefit from NAFTA to establish a presence in Mexico.

Basic Principles

NAFTA established two basic principles guiding the investments in the financial services sector:

- Commercial Presence and Cross-Border Services. Financial service providers of a NAFTA country may establish banking, insurance and securities operations, as well as other types of financial services in any other NAFTA country. Each country may determine the juridical form in which those services provided in its own country may take. Each country must permit its residents to purchase financial services in the territory of another NAFTA country, although the country does not have to allow solicitation activities by such providers in its own territory. Furthermore, a country may not impose new restrictions on cross-border provision of financial services in a sector.
- Non-Discriminatory Treatment. Each NAFTA country will provide both national treatment and most favored nation treatment to other NAFTA financial services providers operating in its territory. "National treatment" means treatment no less favorable than that accorded by a party to its own investors, financial services providers and financial institutions in like circumstances. A NAFTA country may satisfy the requirement of national treatment even though it may treat financial

services providers of another party differently from domestic financial services if it accords "equal competitive opportunities." "National treatment" with respect to measures of a province or state means treatment no less favorable than the most favorable treatment accorded in like circumstances by such province or state to financial service providers of its own country. Certain elements of these basic principles are to be phased in with respect to investments in Mexico over a transition period ending January 1, 2000. Certain temporary safeguard provisions remain available to Mexico in the banking and securities sectors even after the transition period.

Key Points and Primary Impact

US and Canadian financial services providers will now be able to set up subsidiaries to serve the burgeoning Mexican market.

NAFTA can be expected to give added impetus to the drive to eliminate barriers to interstate branch banking in the United States (Paul, Hastings, Janofsky & Walker: 1992, 67-72).

Chapter 15 – Competition and Antitrust, State Enterprises

This chapter addressed competition policy and monopoly concerns. The signatories laid out general commitments to familiar antitrust objectives:

- to apply their domestic competition rules to prevent anti-competitive business practices;

- to cooperate and coordinate in enforcing those rules, and
- to use regulatory controls to assure that state enterprises or state-designated monopolies observe the commitments their government has made in NAFTA – most notably by not discriminating in favor of local suppliers or purchasers to the detriment of businesses established in that country by investors of the two countries.

Chapter 15 contains three central provisions.

Antitrust Cooperation

The parties recognized that preventing anti-competitive conduct will enhance the NAFTA objectives. Each signatory "recognizes the importance of cooperation and coordination among their authorities to further effective competition law enforcement" in the North American zone. The parties agreed to cooperate in such traditional areas of antitrust administration as exchange of information, mutual assistance among their enforcement agencies, and notification of measures taken. Article 1503 specifically exempts controversies over competition policy or enforcement from the NAFTA Dispute Settlement provisions. This assures that the Agreement's procedures for resolving disputes – including the establishment of arbitral panels charged with determining whether the defending country has acted in violation of its NAFTA obligations – cannot be invoked for competition law matters.

Thus, where controversial antitrust actions are taken by tone of the governments in a way that aggrieves another – for example, the approval by the US of a merger between competitors that Mexico believes will result in anti-competitive concentration that will harm Mexican companies in the same business – the complaining government can request consultations. It has no guarantee, however, that the acting government will agree to consult over the action. Nor can it obtain an independent panel review.

<u>State Enterprises and Monopolies</u>

<u>State Enterprises</u>. Article 1503 confirmed that each government is free to establish state-owned enterprises at its discretion. Upon doing so, however, the establishing government must assure, if it has delegated to the enterprise powers to perform governmental functions, that the enterprise does not use those powers to impair the rights of open investment established by Chapter 11 – i.e., national treatment, non-discrimination, and no performance requirements.

In other words, if it is empowered to approve transactions, grant licenses, or impose fees or quotas, a state enterprise must treat the local subsidiaries of the other NAFTA countries the same as it treats its domestic companies. Similarly, it must make its goods or services available to those subsidiaries on a non-discriminatory basis.

<u>Monopolies.</u> Article 1502 confirmed that each government may bestow a monopoly at its discretion. If in doing so it may "affect the

interest of persons of another Party," the government must notify the other Party of the action and must attempt to condition the monopoly so as not to impair NAFTA benefits.

As with state enterprises, the Agreement instructed that monopolies cannot discriminate against the local investments of the other NAFTA parties in exercising licensing, fee-setting, or approval powers or in selling the monopoly good or service. The Agreement also imposed additional rules on monopolies that are not present for more state enterprises. These include:

- The monopoly must act "solely in accordance with commercial considerations" in selling or purchasing the monopoly good or service, "including with regard to price, quality, availability, marketability, transportation, and other terms and conditions of purchase or sale."
- It cannot discriminate against goods or service providers of another Party in buying or selling the monopoly good or service.
- It cannot use its monopoly advantages to engage in anti-competitive acts in non-monopoly markets, "including through the discriminatory provision of the monopoly good or service, cross-subsidization or predatory conduct."

The articles on state enterprises and monopolies do not contain exemptions from the Dispute Settlement provisions of the Agreement. It appears therefore, that a NAFTA company discriminated against by a monopoly or state enterprise may seek to persuade its government to demand consultations, intervention of the NAFTA Trade Commission, or constitution of a NAFTA arbitral panel.

Key Point and Primary Impact

Antitrust concerns will play a major role in determining how successful NAFTA will be in achieving a seamless North American market.

Affected Industries

Energy-intensive manufacturing investments in Mexico will benefit from the rules on non-discriminatory supply of power from Mexico's state-owned electricity and gas monopolies, CFE and PEMEX.

US and Canadian petrochemical plants in Mexico will benefit from provisions (if they are enforced) preventing PEMEX from using its monopoly over basic petroleum production to protect its competitive position in downstream petrochemical areas that have been or will be opened to competitive producers by the Mexican government (Paul, Hastings, Janofsky & Walker: 1992, 73-78).

Chapter 16 – Temporary Entry

The provisions for temporary entry were modeled after those in effect under the US-Canada Free Trade Agreement (CFTA). However, some of the US immigration advantages extended to Canadians under the CFTA may not be available to Mexican citizens under the NAFTA. The illegal immigration of Mexican citizens into the United States has long been a politically sensitive issue, and the United States has chosen under the Agreement to reserve for itself the right to continue imposing some of the restrictions that currently complicate and delay the process of obtaining temporary admission into the US to engage in certain business conduct.

Four main categories of entrants were addressed in the NAFTA: Business visitors, Treaty traders and investors, Intra-company transferees, and Professionals (certain categories).

Taking account of the preferential trading relationship between the NAFTA countries, this section set out commitments by the three countries to facilitate, on a reciprocal basis, temporary entry into their respective territories of business persons who are citizens of Canada, Mexico or the United States. The NAFTA does not create a common market for the movement of labor. Each NAFTA country maintains its rights to protect the permanent employment base of its domestic labor force, to implement its own immigration policies and to protect the security of its borders. Mexico and the US have agreed to an annual numerical limit of 5,500 Mexican professionals entering the United States – this agreement will expire 10 years after the Agreement goes into effect, unless the two countries decide to remove the limit earlier. Canada has not set a numerical limit with Mexico.

Key Points and Primary Impact

- The two most important effects of the NAFTA's immigration-related provisions from a US immigration perspective include: (1) The streamlining of the admission process for Mexican citizens seeking temporary entry for business purposes (the pre-clearances currently required for intra-company transferees and professionals can take as long as three months), and (2) The eligibility of Mexican nationals for treaty trader and investor status (there currently is no treaty with Mexico that would allow this status) (Paul, Hastings, Janofsky & Walker: 1992, 79-82).

Chapter 17 – Intellectual Property

Building on the work done in the GATT and various international intellectual property treaties, NAFTA established a high level of obligations respecting intellectual property. Each country will provide adequate and effective protection of intellectual property rights on the basis of national treatment and will provide effective enforcement of these rights against infringement, both internally and at the border.

NAFTA set a far higher standard for liability in trade cases than has traditionally been required. In addition, NAFTA preserved Canada's so-called "cultural exemption," affording Canada the right to take whatever action regarding cultural materials (i.e., motion pictures, records & books) it deems in its national interest, raising fears of possible quotas and the exclusion of artistic products from the US and other countries.

National Treatment/Minimum Standards of Protection

NAFTA was intended to provide "adequate and effective protection and enforcement of" intellectual property rights by:

- Providing a comprehensive definition of "intellectual property rights";
- Fixing minimum standards for intellectual property protection, set forth in certain of its express provisions and by reference to a handful of well-recognized international treaties; and
- Requiring each Party to accord to nationals of another Party, "treatment no less favorable than" it accords to its own nationals (Paul, Hastings, Janofsky & Walker: 1992, 83-99).

Chapter 18 and 20 - NAFTA Administration and Dispute Settlement Procedures

The Agreement contains provisions establishing an institutional framework for administration of the NAFTA, as well as procedures for settlement of disputes arising under the NAFTA. Other provisions of the Agreement seek to ensure that each Party's laws, regulations and rules affecting trade and investment are transparent and fairly administered.

Institutional Arrangements

Chapter 20 of the Agreement established two institutions to facilitate joint administration of the Agreement and to avoid or settle disputes between Parties regarding interpretation and application of the NAFTA.

The Free Trade Commission

- The Free Trade Commission is to be the "central institution" of the NAFTA, comprised of cabinet-level representatives (presumably the trade ministers) designated by each Party.
- The Commission is responsible for supervising implementation of the Agreement, resolving disputes regarding its interpretation or application, and supervising the work of all committees and working groups established under the Agreement.
- The Commission meets at least once a year in regular sessions, to be chaired successively by each Party. Decision making will be by consensus, unless the Commission determines otherwise.

The Secretariat

- A Secretariat, comprised of national Sections, is to be established, staffed and supported by the Parties.
- The Secretariat will provide administrative assistance to the Free Trade Commission, panels and committees established under Chapter 19 (involving Review of Antidumping and Countervailing Duty Matters) and NAFTA dispute resolution panels.

Dispute Resolution

NAFTA Dispute Resolution. The Agreement contemplated three stages for resolution of disputes arising under it: consultations, review by the Trade Commission, and referral to an arbitral panel. Formal NAFTA dispute resolution begins with consultations, which are intended to be the primary means of settling disputes. If consultation fails to yield a resolution within 30-45 days after initiation (15 days for disputes involving perishable agricultural products), a consulting Party may request a meeting of the Trade Commission. The Commission may rely on technical advisors, convene working groups or experts, or seek conciliation, mediation or other dispute resolution procedures in an effort to resolve the dispute promptly. If a matter referred to the Commission is not resolved within 30 days, any consulting Party can request the establishment of an arbitral panel. A third Party that considers it has a substantial interest can join as a complaining party before the panel.

Arbitral panel procedure. NAFTA arbitral panels will operate on a model similar to panel dispute settlement under the GATT. The panel will consist of five members ordinarily chosen from a roster of experienced experts in the fields of law, trade or other matters covered under the Agreement. The Agreement sets forth a complex method of selection of panel members in which the disputing Parties first agree on the Chair of the panel. Each then selects two additional members, who are to be citizens of the other disputing Party. The Commission will establish Model Rules of Procedure for arbitral panels that ensure at least one hearing and the opportunity to provide initial and rebuttal written submissions.

Panel procedures will permit reliance on a specially selected scientific review board on any factual issue concerning environmental, health, safety or other scientific matters at issue in the proceeding.

The panel will issue an initial and a final report evaluating the dispute. The Parties will then normally agree to conform with any determinations and recommendations of the panel. Resolution should, whenever possible, take the form of non-implementation or removal of a nonconforming measure, or failing such a resolution, compensation.

If the panel determines that a measure taken by a Party is inconsistent with obligations of the NAFTA or impairs specified benefits provided under the Agreement, and the Parties have not reached a mutually satisfactory resolution, the complaining Party may suspend the application of equivalent benefits to the other Party until they have reached an agreement. Upon application of a Party, the Commission is called upon to establish a panel to determine whether the complaining Party's suspension of benefits is "manifestly excessive."

Disputes Cognizable under the GATT

- Because many of NAFTA's provisions are based on or similar to the obligations imposed by the GATT, in many instances a complaining government will be able to contend that the offender has violated both its NAFTA commitments and its GATT obligations. In these circumstances, NAFTA allows the complaining Party to choose either forum.

- However, if the complaining Party chooses the GATT, it must first notify the third NAFTA Party. If the third Party seeks to join as a complainant and wants the dispute settled under the NAFTA procedures, the two complaining Parties must consult with a view to agreeing on a single forum. If the Parties cannot agree, the dispute normally must be settled under the NAFTA.
- In any dispute brought by one Party against another Party under the GATT, the responding Party can insist that the dispute be settled by a NAFTA panel if it involves factual issues regarding standards-related environmental, safety, health or conservation issues, or if the dispute arises under specific environmental agreements.

Administration of Laws

Under Chapter 18 of the Agreement, each Party must seek to:

- Ensure that its laws, regulations, procedures and administrative rulings regarding any matter covered by the Agreement are promptly published or otherwise made available to interested persons and the other Parties.
- Provide interested persons and Parties reasonable notice and an opportunity to comment on measures it proposes to adopt.

- Notify affected Parties, or provide to a Party upon request, information regarding any proposed or actual measure the implementing Party considers might materially affect operation of the Agreement or otherwise substantially affect another Party's interests under the NAFTA.
- Ensure its measures of general application that may affect matters under the Agreement are administered in a consistent, impartial and reasonable manner involving appropriate notice and opportunity for comment, factual presentation and argument, and the means to obtain prompt judicial, quasi-judicial or administrative review of adverse decisions (Paul, Hastings, Janofsky & Walker: 1992, 100-103).

CHAPTER 19 – ANTIDUMPING AND COUNTERVAILING DUTY MATTERS

Despite Mexico's efforts (with the support of Canada) to use the NAFTA process to win modifications in the US antidumping ("AD") and countervailing duty ("CVD") laws, the United States succeeded in preventing the NAFTA from reaching the substance of these trade laws. Under the Agreement, each Party "reserves the right to apply its antidumping law and countervailing duty law to goods imported from the territory of the other Party." Instead, Chapter 19 of the NAFTA focused almost exclusively on new procedures for the review of AD and CVD decisions rendered by the administrative bodies of each country.

Key provisions of the chapter include the establishment of binational review panels as an alternative to judicial review of AD and CVD determinations, establishment of "extraordinary challenge" committees to ensure the proper handling of reviews by the binational panels, and a mechanism for convening a special committee to determine whether application of a Party's domestic law has hindered the operation of a binational review panel or the implementation of one of its decisions. This latter provision was included in response to concerns that Mexico's laws and judicial system might interfere with the binational review process. The chapter contains a separate provision under which new amendments to a Party's AD or CVD statutes may be reviewed by a panel to determine that the amendments (i) are consistent with the GATT and the objectives of the NAFTA; and (ii) do not operate to overturn a prior decision of a binational review panel.

Binational Review Panels

Carrying forward the model established in the 1988 Canada-US FTA, NAFTA provided for the establishment of independent binational review panels in place of judicial review of final administrative AD or CVD decisions of one Party that involve goods imported from another Party. The panels are to consist of five people assembled on case-by-case basis usually from a roster selected by the Parties. Each Party involved in the decision to be reviewed is entitled to select two panelists, and the fifth panelist is named by agreement of the two Parties. (If no agreement is reached, the Parties decide by lot which of them selects the fifth panelist.)

A Party on its own initiative can, or at the request of a person ordinarily entitled to seek judicial review must, request panel review of a final AD or CVD determination. If panel review is requested, it precludes judicial review of the administrative decision. If panel review is not requested, domestic judicial review procedures still apply. The role of the panel is to ascertain whether the administrative determination was in accordance with the domestic AD or CVD law of the Party that rendered it. The panel can uphold the final determination or remand it for action not inconsistent with the panel's decision. The decision of the review panel is binding and cannot be appealed to a court.

Key Points and Primary Impact

Chapter 19 preserved much of the structure and substance of the AD and CVD dispute settlement provisions of the Canada-US Free Trade Agreement. This is not surprising, because positions of the parties going into the NAFTA negotiations mirrored those of the US and Canada during the formulation of the earlier agreement. Both Canada and Mexico (like Canada in the 1988 FTA talks) wanted to use the NAFTA negotiations to win substantial relief from the US AD and CVD laws. The United States, in contrast, was not prepared to accept any substantive weakening of its trade laws. The US position remains firm that any such changes must be discussed on a global basis in the Uruguay Round of the GATT, where

AD and CVD rules remain an area of sharp debate. Instead, Chapter 19 simply contains an Article in which the Parties agree "to consult on the potential to develop more effective rules and disciplines concerning the use of government subsidies and the potential for reliance on a substitute system of rules for dealing with unfair transborder pricing practices and government subsidization (Paul, Hastings, Janofsky & Walker: 1992, 104-108)."

ENVIRONMENTAL REGULATION UNDER NAFTA

The NAFTA text addressed environmental requirements only in the context of more general language on technical standards. The effect of those provisions is not to add further or more stringent requirements to the national law of any signatory, but rather is to preserve both existing national and international requirements and the full power of each signatory (including subauthorities, such as States or Provinces) to add or maintain environmental regulations, provided that the requirements are not discriminatory and have a reasonable scientific basis. There is a long term goal of ultimate harmonization of requirements that should, by denying an obligation to lower standards, cause an eventual tightening of Mexican requirements to bring them more into line with US and Canadian requirements.

Factual issues that arise in relation to enforcement of a signatory's standard may be referred to a Committee established by NAFTA.

However, the dispute resolution cannot require a country to alter or lower its environmental standards.

Environmental Agreements

Article 104 specified that in the event of inconsistency between NAFTA and trade obligations set forth in specific international agreements, the obligations in the other agreements, and not NAFTA apply -- provided that if there are equally effective, reasonably available means of compliance, the parties will choose the alternative that is least inconsistent with NAFTA.[4]

Under the NAFTA provisions as drafted, Mexican environmental standards may eventually become more stringent (as they become "compatible" with US and Canadian standards), and there will be clear opportunities for industry and citizen groups to obtain copies of proposed changes and of the relevant information. Where appropriate, industry or interest groups may press a signatory to raise the proposal or regulation as a matter of technical consultation.

[4] The agreements covered include the Convention on International Trade in Endangered Species, the Montreal Protocol on Ozone Protection, the Basel Convention on Transboundary Movement of Hazardous Waste, the US-Canada Bilateral Treaty on Transboundary Movement of Hazardous Waste, and the US-Mexican Agreement on Improvement of the Environment in the Border Area.

The negotiators contend that nothing in NAFTA will reduce or eliminate existing US standards, or prevent the enforcement of those standards as they may apply to goods or services from the other signatories. Some environmental groups, however, fear the US federal or state regulation will be subject to challenge on grounds that the scientific basis for the regulation is insufficient (Paul, Hastings, Janofsky & Walker: 1992, 109-112).

CHAPTER IV

NAFTA OVERVIEW

Liberalization and National Policy Flexibility and Sovereignty

Governments generally undertake trade and investment liberalization as part of overall national economic reform strategies aimed at maximizing the welfare of their citizens. For the most part, liberalization is a means to important ends, whereby improved international competitiveness may actually increase a country's room to maneuver on domestic economic and social policies by improving its national income and making it less vulnerable to external shocks. In this way key aspects of sovereignty may be seen as strengthened rather than diluted – in a rapidly changing world. The challenge remains to convincingly present liberalization strategies and decisions as reinforcing sustainable economic growth to the wider benefit of societies, rather than as ends in themselves.

Liberalization is never imposed on countries by other countries. Rather, international negotiations are a way for governments to seek trade rules by which participants agree to play in the future. In these international negotiations, democratic governments represent their citizens. Furthermore, market liberalization does not involve the wholesale dismantling of domestic regulatory measures. On the contrary, liberalized markets rely on effective and efficient domestic regulations to maintain public standards or protect public interests in a large number of areas, including *inter alia*, customs inspection, clearance and control, product quality and safety assurance systems, environmental quality and protection and the prudential oversight of banking and finance. The market turmoil experienced by a number of countries stems from a lack of sound regulatory framework for financial market supervision, supplemented by domestic regulatory reforms to improve the efficiency and transparency of market functions and the quality of regulatory performance therein. This is a matter for national decision-making rather than something that is directed or imposed externally.

For the most part, multilateral trade and investment agreements do not aim to put into question *objectives* of national policies or regulations, whether on trade investment of any other matter. But market access liberalization and international trade does not relieve participants from health and safety procedures to protect individuals and agricultural food products. In this instance, there is consensus to protect societies (Johnston: 1998, 78-79).

When NAFTA was negotiated, Mexico first resisted including material on labor standards and the environment. At US insistence, these issues were included in the body of the NAFTA text. Then presidential candidate Bill Clinton asserted that these provisions were inadequate and supplemental agreements were required. Mexico resisted, but then assented and indeed made concessions on potential trade penalties for consistent violation of its own standards. These are not major derogations of Mexican sovereignty in that the potential penalties are insulated by complex procedures, but they are intrusions. They were extracted under the pressure exerted by interested parties in the United States as the price of obtaining congressional approval of NAFTA (Weintraub: 1994, 11).

Many members of the US Congress opposed NAFTA on the ground that Mexico had an authoritarian regime and the United States should not enter into a free trade agreement with a country in which there are many charges of violation of human rights and whose electoral process is flawed. There is constant pressure from the United States for Mexico to become more democratic if NAFTA is to deepen into strong integration. When the rebellion of indigenous groups erupted on January 1, 1994, (the very date NAFTA became effective) in the southern Mexican state of Chiapas, the first reaction of the Mexican authorities was to ruthlessly suppress the insurgency. Protests came from within Mexico and from the United States as well. Congressional hearings were called to assess the state of democracy in Mexico. The US reaction must have influenced the shift in Mexico policy from suppression of the rebellion to negotiation and mollification of the insurgents. Mexico, in this sense, lost some control over its internal affairs because the existence of NAFTA increased outside scrutiny (Weintraub: 1994, 11-12).

The more NAFTA deepens, the more sovereignty issues will be raised on such matters of protection of national industry, handling trade disputes, and protection of the environment. US attention to the growth of democracy in Mexico will not diminish, particularly if NAFTA deepens. Sovereignty arguments may often be a cloak for other agendas, such as protectionism, but they are apt to find much resonance in the three countries, each of which is highly nationalistic in its own fashion (Weintraub: 1994, 12).

Why would the US, an industrial country, sign a trade agreement with Mexico a developing country? The United States for its part, had four basic political goals. One was the preservation of stability on its southern border. This had been the cornerstone of US policy toward Mexico ever since the revolution of 1910. The idea was that NAFTA would stimulate economic growth in Mexico, easing social pressure and sustaining the regime. Notwithstanding public rhetoric, it was not Washington's primary intent to promote democratic change; it was to uphold political peace.

Second, the US sought to assure itself of increasing access to petroleum from Mexico, one of the five leading sources of US imports. (Mexican shipments in the late 1980s and early 1990s were roughly half as large as those from the topmost source, Saudi Arabia.) Petroleum continued to have major geostrategic significance, as the Persian Gulf War eloquently testified, and secure and steady access to sources within the hemisphere could counterbalance the potential costs of political turbulence elsewhere in the world. During the NAFTA negotiations Washington strenuously attempted to obtain rights for US firms to engage in excavation. Mexico firmly resisted this demand, on the ground that it would contravene the constitution of 1917, but opened other opportunities for US participation in the petrochemical sector.

Third, NAFTA provided the United States with an important bargaining chip in its trade negotiations with Europe, Japan and the General Agreement on Tariffs and Trade. In confronting a potential "fortress Europe" or a resistant Japan, in other words, Washington could threaten to form an exclusive economic bloc in North America – or perhaps the Western Hemisphere as a whole – and pursue highly protectionist policies. Ironically, the international community eventually interpreted the ratification of NAFTA as a vote in favor of free trade, rather than protectionism, a development that helped restore US leadership in the world arena.

And fourth, the US wanted to consolidate diplomatic support from Mexico on foreign policy in general. As demonstrated by disagreements over Central America during the 1980s, foreign policy had long been a source of bilateral tension. And with NAFTA in place, Mexico became unlikely to express serious disagreement with the United States on major issues of international diplomacy (Smith: 1996: 246-247).

Conversely, Mexico was seeking, first and foremost, preservation of its social peace. The hope was that NAFTA would attract investment, stimulate employment, and provide meaningful opportunity for the one million persons entering the job market every year. This would alleviate poverty, reduce social tension, and perpetuate the country's political regime. In this sense the goal of the PRI was thoroughly compatible with Washington's desires to prolong stability in Mexico.

Second, NAFTA offered President Salinas an opportunity to institutionalize and perpetuate his economic reforms, i. e., liberalizing trade, privatizing the parastatal sector, encouraging foreign investment, and redefining the role of the state. Such policies were threatening to long-established interests in Mexico and caused a good deal of resentment. In order to preserve his innovations, Salinas wanted to insulate them from the historic vagaries of presidential succession, which permitted each new chief executive to reverse or ignore predecessor policies. Under NAFTA, however, the Salinista program of "structural readjustment" now became part of an international treaty – one that was subscribed to by the world's only remaining superpower.

Third, Mexico was seeking international benediction for its not-quite-democratic political regime. Such acceptance was especially important because, in comparison with Argentina, Chile, Brazil and other countries undergoing processes of "democratization," Mexico no longer looked like a paragon of political civility. Prospects for democratization in Mexico became a matter of prominent debate. Skeptics insisted that NAFTA would strengthen and consolidate Mexico's authoritarian system. Advocates maintained that NAFTA would promote democracy by unleashing social forces that would ultimately lay the foundation for democratic development in Mexico. According to this logic, the Mexican political regime deserved approbation not because of its authoritarian present but because of its democratic future. Mexico was seeking legitimation through anticipation.

Finally, Mexico believed that NAFTA would provide the country with diplomatic leverage vis-à-vis the rest of Latin America and by extension, the Third World as a whole. Association with Canada and the United States would link Mexico with advanced industrial democracies and leaders of the "first world." The negotiation of NAFTA would in the long run strengthen Mexico's diplomatic and political prestige (Smith: 1996, 247-248).

What were the US and Mexico national objectives and have these been achieved?

United States Objectives

The United States had several fundamental objectives for pursuing negotiations toward a NAFTA. At the broadest level, the US has a strong and abiding interest in promoting economic growth, political stability, and progress toward greater democracy in Mexico. More importantly, the US is interested in reducing the risk of instability on its southern border. A meaningful FTA can make a valuable contribution toward those goals (Hufbauer, Schott: 1992, 10). Fundamentally, the US has an important economic stake in trade with Mexico, already its second-largest trading partner. Even more important, a NAFTA would promote the efficient use of natural and human resources in the North American region, and thus enable US firms and workers to compete more effectively in world markets. In addition, a NAFTA would reinforce ongoing Mexican trade and investment reforms, which, along with reforms in Mexican laws relating to intellectual property rights, have generated substantial new opportunities for US firms. If Mexico's recent strong growth performance can be maintained, net US exports to Mexico should expand substantially, generating net US employment gains in turn. Furthermore, growth in the Mexican economy will create new jobs and higher wages in Mexico and eventually slow the tide of illegal immigration (which is still a problem and may remain one for years to come) (Hufbauer, Schott: 1992, 11).

In the aggregate, the direct, static benefits to the United States from the elimination of Mexican trade barriers will be small but not inconsequential. This reflects the fact that the Mexican economy today is relatively small, with a GNP less than 4 percent that of the US economy. In addition, US exporters have already reaped some of the benefits to be derived from lower Mexican trade barriers as a result of the substantial trade reforms that Mexico has embraced unilaterally since 1985. However, the benefits of unilateral trade liberalization can be transitory; a NAFTA would secure and augment those reforms in an international accord and thus ensure that the benefits for US trading interests will be maintained (Hufbauer, Schott: 1992, 11).

The potential dynamic gains for US exporters from the NAFTA could be significant. The NAFTA would contribute to rapid growth in Mexican income and employment. Within four decades, Mexican per capita income could reach the same level that the United States attained in 1988 – glowing prosperity compared with today's grinding poverty. A prosperous Mexico would become a thriving market for US exports (Hufbauer, Schott: 1992, 11).

Hufbauer and Schott illustrate the potential dynamic trade gains on Mexico imports based on $300 per capita annually for the United States; in contrast Canada's annual imports from the United States run about $3,000 per capita (Weintraub, 1990). Mexico already purchases about 70 percent of its imports from the United States; with a strong growth in the Mexican economy, most of Mexico's additional purchases will also come from the US market. Although Mexico will not reach the per capita import levels of industrialized Canada any time soon, annual US sales to Mexico are estimated to increase from $28 billion in 1990 to nearly $60 billion by 1995 (12). As of July 1999, US sales to Mexico reached $61 billion.[5]

For the United States then, the NAFTA reforms should enhance an already important export market. US exports to Mexico have grown sharply since 1986 and now run at an annual rate of about $42 billion. US suppliers of intermediates, capital goods, and high-technology products should continue to reap large benefits as prime suppliers of the growing Mexican market. Over time, the NAFTA meets key US foreign policy objectives. The US debate often ignores the foreign policy dimension, blithely taking for granted that Mexican steps toward economic reform and political pluralism are irreversible. But Mexico's economic reforms are still vulnerable to political and financial shocks, and democratic reforms are still in their infancy. The NAFTA should anchor achievements already made in Mexico and reinforce efforts to promote economic growth and political pluralism in that country.

Mexico's Objectives

Mexican objectives for a NAFTA negotiation are quite specific. First, a FTA with the United States would yield more open and secure access to a market that accounts for three-quarters of total Mexican exports. A NAFTA would reduce the threat of US protectionism and enhance Mexican export opportunities in the US market. Second, international communities under a NAFTA, together with prospective

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[5] Source: US Department of Commerce, Office of NAFTA, 1999.

GATT accords, would help lock in domestic Mexican reforms instituted since 1985. In the initial wave of liberalization, licensing requirements were cut back for about 3,600 items, leaving 908 items under control. Since then the maximum tariff level has been cut from 100 to 20 percent, the trade-weighted average tariff has fallen to just above 10 percent, most licensing requirements have been eliminated, and the official reference prices for customs valuation purposes have been progressively removed. In addition, regulations regarding foreign investment and technology transfer have been liberalized and the intellectual property laws substantially revamped. These reforms have been complemented by substantial deregulation and privatization in key sectors, including banking, telecommunications and transport (Hufbauer, Schott:1992, 12).

In 1985 to the end of 1986, the peso was severely depreciated, which delayed new trade. As a result, the trade liberalization package did not immediately lead to an import surge, and Mexican industry was temporarily insulated from structural adjustments. In 1987, the peso sharply appreciated by 22 percent in real terms. In addition, the Mexican government announced the Economic Solidarity Pact, which increased prices of public goods and services, cut back government spending, ended the indexation of wages to inflation, and continued the 1985 trade liberalization measure. Imports immediately increased by more than 50 percent, from $12 billion in 1986 to $19 billion in 1987, reflecting pent-up demand not only for consumer goods but also for immediate and capital goods that were in short supply in the Mexican economy. This time, Mexican industry felt the full brunt of international competition and had no choice but to pursue a rigorous program of cost cutting and retrenchment (Hufbauer, Schott: 1992, 12).

For Mexico, the NAFTA reinforces the extensive market-oriented policy reforms implemented since 1985, i. e., privatization and deregulation. These reforms have promoted real annual growth of 3 to 4 percent in the 1990s and a falling rate of inflation. The NAFTA portends a continuation of the fast pace of change in the Mexican economy by extending the reform process to sectors such as autos, textiles and apparel, finance, telecommunications, and land transportation. Mexican exporters will also benefit in two distinct ways: the relatively unfettered access to the US market that they already enjoy under various unilateral US programs will be sustained, and the few remaining US trade barriers will be liberalized. The prospect of NAFTA implementation has already generated strong expectational effects, with capital inflows to Mexico estimated at about $18 billion in 1994 (of which $5 billion was probably foreign direct investment). These large inflows are the financial counterpart to the growing Mexican current account deficit generated by imports of machinery, equipment, and other capital goods -- all essential ingredients for the sustained development of the Mexican economy (Hufbauer, Schott: 1993, 3-4).

Effects of NAFTA on the United States

The formation of NAFTA benefits the United States by increasing competition in product and resource markets, as well as by lowering the prices of many commodities to US consumers. The US Chamber of Commerce estimated that US trade with Mexico would double within a decade and it will also increase US competitiveness *vis-à-vis* Europe and Asia. Opponents on the other hand, predict that NAFTA will trigger an exodus of US factories to Mexico to take advantage of much lower Mexican wages, thus increasing unemployment in the United States. They also believe that NAFTA will result in unfair competition for US plants because of much more lax environmental and labor regulations in Mexico. Most economists, however, agree that while some labor-intensive industries, such as textiles and apparel, are likely to be hurt, the benefits gained by US high-tech and export industries will more than make up for losses.

Because the US economy is more than nine times larger than Mexico's economy, the US gains from NAFTA as a proportion of its GDP will be much smaller than Mexico's. Furthermore, with wages in the United States more than six times higher than in Mexico, NAFTA can be expected to lead to a decline of 150,000 unskilled jobs in the United States. Skilled jobs, however, will increase by 325,000 for an overall net increase in employment of 175,000 in the United States (Hufbauer and Schott, 1992). Low wage areas of the US (such as Alabama and

Arkansas) will suffer while high wage areas will gain, but with a 15-year phase-in period and assistance to displaced workers, the harm to workers in low income areas in the United States will be minimized.

Free trade access to Mexico will allow US industries to import labor-intensive components from Mexico and keep other operations in the United States rather than possibly losing all jobs in the industry to low wage countries. This will also make the United States more competitive in the world economy. In fact, some of the jobs that Mexico would gain in the near future may not come from the United States but from other countries, such as the newly industrializing Asian countries of South Korea, Taiwan, Hong Kong, and Singapore, where wages are now roughly equal to Mexico's. Supporters of NAFTA point out that the demand for a 'social charter' similar to that contemplated by the European Community (EC) to promote uniform labor standards throughout North America is put forward by opponents simply to kill NAFTA since Mexico, as a developing country, cannot and should not replicate exactly all US and Canadian labor laws (Salvatore: 1994, 22-24).

Effects of NAFTA on Mexico

In Mexico, the implementation of NAFTA is likely to greatly stimulate the process of transformation that had already started during the second part of the last decade. In 1986, Mexico joined GATT and began the process of dismantling tariff and nontariff barriers, which until then had ranged from 35 to 100 percent. Then, in 1988, when Carlos Salinas de Gortari became President, he began to cut down the size of the government bureaucracy, diversify the Mexican economy from oil, and privatize the economy. The establishment of NAFTA would benefit Mexico by: (1) leading to greater export-led growth resulting from increased access to the huge US market, (2) encouraging the return of flight capital (i.e., capital that left Mexico in search of higher and more secure return abroad, mostly in the United States), and (3) fostering more rapid structural reforms domestically (so as to recover from the 'lost decade' of the 1980s, when growth ground to a halt under the burden of a hugh international debt and foreign protectionism).

The successful operation of NAFTA will also sharply reduce the risk that US investors have traditionally faced in Mexico and hence stimulate direct as well as financial investment in Mexico. With lower risks and higher growth, returns on most types of investments in Mexico are likely to increase faster than in the United States and this will further increase US financial as well as industrial investments in new plants and equipment in Mexico. For example, foreign direct investment in Mexico doubled between 1985 and 1990 and increased by another 50 percent between 1990 and 1991. The US automobile industry is likely to be one of the main beneficiaries from NAFTA. The United States currently imposes only a 2.5 percent tariff on imported autos while Mexico imposes a 20 percent tariff. Furthermore, Mexico currently requires that for every dollar spent on imported autos, two dollars' worth of Mexican-made cars be exported. By removing these restrictions, NAFTA would lead to the US auto industry gaining major benefits.

Many studies have been done to indicate that trade liberalization, improved investor confidence, and endogenous productivity growth is expected to raise Mexico's welfare by 11 percent by the end of the decade and productivity per worker by 50 percent in 25 years. Dismantling agricultural restrictions is estimated to release 800,000 farm workers in Mexico (of which 600,000 are expected to migrate to become urban unskilled workers in the United States) in the first year and almost two million workers cumulatively over time. Grain and live stock producers would gain in the United States and lose in Mexico, while the opposite is expected to occur to fruit and vegetable growers. Overall, farm income is estimated to rise by more than $200 million in the United States and fall by more than $400 million in Mexico. Of course, this net loss of agricultural income in Mexico is expected to be made up several times over by gains in industry and services. As a result of more rapid economic development, pollution is likely to increase in Mexico, especially along the US-Mexican border, but as incomes rise, Mexico is likely to take stronger measures to reduce pollution – at least this is what has been observed as developing nations grow past the level of development now reached by Mexico (Salvatore: 1994, 24-25).

Increasing employment opportunities in Mexico and rising wages are also expected to reduce the pressure that many Mexicans now face to emigrate to the United States. But with wages in Mexico now so much lower than in the US and with large yearly increases in population and labor force in Mexico, it may take many years for a significant reduction in the push and pull forces that Mexicans now face to migrate to the United States (Salvatore: 1994, 24-25).

CHAPTER V

Contemporary Economies of the US and Mexico since NAFTA

Mexico's Economy

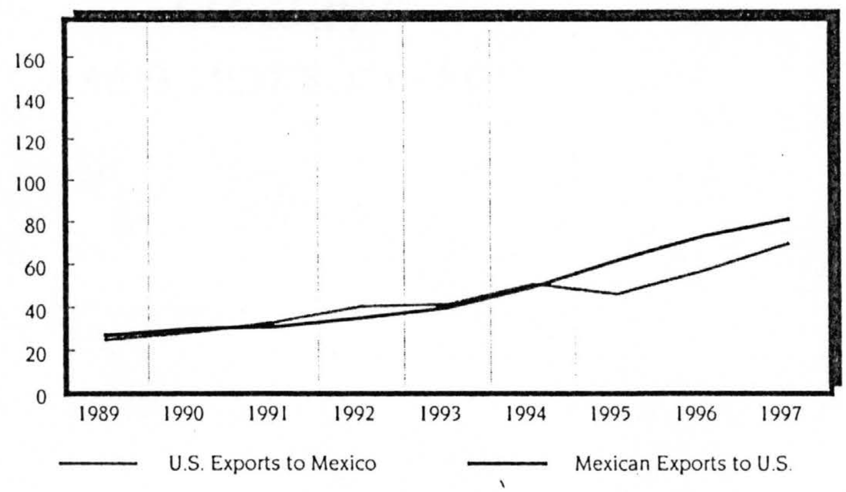
Mexican trade with the United States has been enormously influenced by the monetary crisis that began in December 1994, when the peso dropped from about 3.4 to the US dollar to 5.3 in just seven days. The peso continued to decline and the 8.25 pesos to the dollar rate that prevailed into late 1997 cut the cost of Mexican goods for US and Canadian importers to less than half that before the crisis and doubled the cost of imports for Mexicans. Such sharp changes in effective price overwhelms any effect that lower tariffs required by NAFTA may have had. Moreover, the ratio of US to Mexican hourly compensation costs in US dollars has risen from 6.9 to1 in 1993, prior to implementation of the agreement, to 11.8 to 1 in 1996. This not only increases the competition from Mexican imports, but makes it much more profitable to move production south. Seen in this light, it is remarkable that US and Canadian trade deficits with Mexico are not larger (Cremeans: 1998, 11).

Mexican exports to the United States and Canada continued to rise following the implementation of NAFTA (Figure 1). Mexican exports to the United States grew at a 19.4 per cent annual rate from 1993 to 1997, almost double the growth rate of the preceding four years; Mexican

FIGURE 1

Mexican-US Trade in Goods, 1989-1997

Billions of US dollars



Source: US Bureau of Census and editor's estimates

(Cremeans: 1998, 11)

imports from the United States grew 13.7 per cent annually over the same period, almost the same as in the comparable period prior to NAFTA. Although percentage growth in Canadian-Mexican trade has been strong, Canada's trade with Mexico in 1996 was only 2 per cent of Canada-US trade. It seems to have been greatly influenced by the implementation of NAFTA due to the elimination of barriers to trade in goods and services (Cremeans: 1998, 12).

US exports to Mexico did fall immediately after the peso crisis (Table 1). But they fell far less in the 1994-1995 peso crisis than they did in the Mexican monetary crisis of 1982. US exports to Mexico

TABLE 1

Bilateral Trade in Goods Among NAFTA Countries

(Million of US dollars)

	1989[1]	1990	1991	1992	1993	1994	1995	1996	1997[2]
BILATERAL TRADE: NAFTA									
U S Exports to Canada	78,809	83,674	85,150	90,594	100,444	114,439	127,226	133,668	146,079
Canadian Exports to U S	87,953	91,380	91,064	98,630	111,216	128,406	145,349	156,506	159,483
U S Exports to Mexico	24,982	28,279	33,277	40,592	41,581	50,844	46,292	56,761	69,482
Mexican Exports to U S	27,162	30,157	31,130	35,211	39,917	49,494	61,685	72,963	81,000
Canadian Exports to Mexico	524	551	492	662	619	772	810	856	1,048
Mexican Exports to Canada	1,442	1,498	2,251	2,294	2,876	3,313	3,898	4,394	4,878
TRADE BALANCES WITHIN NAFTA[3]									
Canada	8,225	6,759	4,155	6,404	8,515	11,427	15,035	19,300	9,574
Mexico	3,099	2,825	(388)	(3,749)	593	1,190	18,481	19,740	15,348
U S	(11,324)	(9,584)	(3,767)	(2,655)	(9,108)	(12,617)	(33,516)	(39,040)	(24,922)

1 1989 and earlier data on U S exports to Canada are not comparable with data for 1990 and later years because of a change in the reporting system The NAFTA trade balances for the U S and Canada also are affected

2 1997 figures are projections by the editors

3 Parentheses indicate an excess of imports over exports Because of commodity coding and other data differences among the three countries, these trade balances are only rough estimates and should be used with caution

Source U S Bureau of the Census and Statistics Canada

(Cremeans: 1998, 10)

resumed their rapid growth in 1996, and the Mexican recovery is now well established. This suggests that the agreement may actually have helped ameliorate the effects of economic instability in Mexico. In previous Mexican economic crisis, the government moved to restrict imports. In the 1994-1995 crisis, the government did not restrict imports, and it carried out tariff reductions called for in the NAFTA agreement on schedule. US exports to Mexico increased sharply in 1997 and exceeded US exports to Japan in the first nine months of 1997 (Cremeans: 1998, 12-16).

The Peso Crisis

Two events preceded the peso crisis, Chiapas and the assassination of Luis Donaldo Colosio. Political instability and rising trade deficits made it apparent that the peso would have to be devalued and by the end of Salinas' term Mexico's reserves were rapidly diminishing. Zedillo began his term with an overvalued peso and increasing instability in Mexico. A key part of Mexico's anti-inflation program was to peg the peso to the US dollar. The peg was allowed to "crawl" downward at the maximum rate of 0.0004 pesos a day, making investors very nervous.

The peso survived a speculative attack in March and another in November, but only because the Bank of Mexico emptied its coffers of foreign exchange defending it. On December 21, 1994, the peso was devaluated by 15 per cent. The market reacted sharply and the result was catastropic for Mexico and its government. Suddenly no one wanted to hold the peso and the administration was forced to float the peso, whose value fell to 5.3 to the dollar. The decline continued throughout 1995, and by December the peso was valued at only about 7.5 to the dollar. The consequent recession was one of the sharpest and deepest in modern Mexican history.

The government and corporations were stuck with crushing debt – leaving everyone impoverished. Early in 1995, President Clinton proposed a plan to guarantee up to $40 billion in loans to the Mexican Government to prevent default on outstanding bonds. The US Congress would not go along, however, so the President developed a new plan under his emergency powers in which the United States loaned Mexico $20 billion for 3 to 5 years, the International Monetary Fund loaned $17.8 billion, and the Bank of International Settlements loaned $10 billion. This support calmed the immediate crisis and the peso stabilized, although at a substantially reduced level. In October 1995, President Zedillo announced the repayment of $700 million of those loans and noted that $468 million in interest had already been paid.

Many observers argue that Mexico did not deserve the cruel punishment of a deep recession. The devastating drop in the peso was due more to the fears of the international financial community than to any fatal weakness in the Mexican economy. Prior to December 1994, Mexico was considered the very model of a developing economy benefiting from market-oriented reforms. The technocrats had accomplished a great deal. They had gained control of hyperinflation, brought the budget within bounds, privatized many inefficient government properties, opened the nation to foreign trade, and made the central bank independent of government. In the 1988-1993 period, foreign investment grew rapidly, making growth in consumer and producer imports possible and sparking modest growth in the economy. The economy had not yet "taken off" as hoped, but a number of observers thought Mexico was poised for sustained growth.

The recession was relatively short. The peso devaluation effectively doubled import prices and cut export prices by more than half. Imports were sharply curtailed, but exports remained strong and actually accelerated. The largely foreign owned or operated plants in the duty-free Maquiladora manufacturing sector led the economy out of the recession. Maquiladora output – as measured by value added – showed no decline and actually accelerated with the fall of the peso as Mexican exports became cheaper. Manufacturing as a whole declined by about 3.75 per cent in the first quarter of 1995, but recovered quickly. Worker's wages fell in both current and constant terms throughout the economy, but manufacturing wages regained their pre-recession peso level by the third quarter of 1996. Imports also picked up and reached their pre-recession level by about the same time. Even the construction industry, which suffered sharply from the crash, had recovered by the second quarter of 1996.

The Mexican economy has stabilized, but most Mexicans still are feeling the effects. Many families have lost their savings, have lower real earnings, and can no longer afford imported goods that were once considered necessities. Nonetheless, one of the worst recessions since the 1930s was also one of the shortest and the economy is again growing.[6] Instituto Nacional de Estadistica Geografia e Informatica (INGEI) reports 5.1 per cent real growth from the first quarter of 1996 to first quarter of 1997, and unemployment reduced to 3.4 per cent by June 1997 (Cremeans: 1998, 12-13).

The United States Economy

Critics predicted that NAFTA would bring factory closures, lost jobs, and falling wages. Imports from both Canada and Mexico did grow following the implementation of the respective free trade agreements, and at higher rates than in the comparable period preceding the agreement[7] (See Tables 1 and 2). Jobs have been lost, but not at the rates predicted. Overall employment growth has been strong, and the unemployment rate has been falling since 1993 – it dropped to 4.6 per cent in November 1997 (Cremeans: 1998, 13).

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[6] See Inter-American Development Bank, "Mexico-Situacion economica reciente, "Oct. 1997.
[7] This analysis reviews US Canadian trade from the implementation of the CUSFTA in 1990; US-Mexican trade is analyzed from the implementation of NAFTA in 1994-1996.

TABLE 2

Growth in Bilateral Goods Trade Before and After NAFTA

(Compound annual growth rate)

	1989-93	1993-97	PERCENTAGE POINT DIFFERENCE
U S exports to Canada	6 25	9 82	3 56
Canadian exports to U S	6 04	9 43	3 39
U S exports to Mexico	13 58	13 70	0 11
Mexican exports to U S	10 10	19 35	9 25
Canadian exports to Mexico	4 27	14 04	9 77
Mexican exports to Canada	18 83	14 12	(4 71)

Source Calculated by the editors from trade data from the U S Bureau of the Census and Statistics Canada

(Cremeans: 1998, 10)

US-Mexico trade has also increased substantially. US exports to Mexico have grown at a 13.7 per cent rate (based on 1997 projections) virtually unchanged from the pre-NAFTA rate, despite the depreciation of the peso. Mexican exports to the United States have grown at a 19.4 per cent rate – almost doubled the pre-NAFTA rate (See Table 2).

The United States had a trade surplus with Mexico of about $5 billion in 1992; based on current projections, the 1997 trade balance will show a deficit of about $11 billion. If one judges the value of NAFTA solely on the change in the US trade balance since its implementation, as some of its opponents do, NAFTA has not been good for the US.

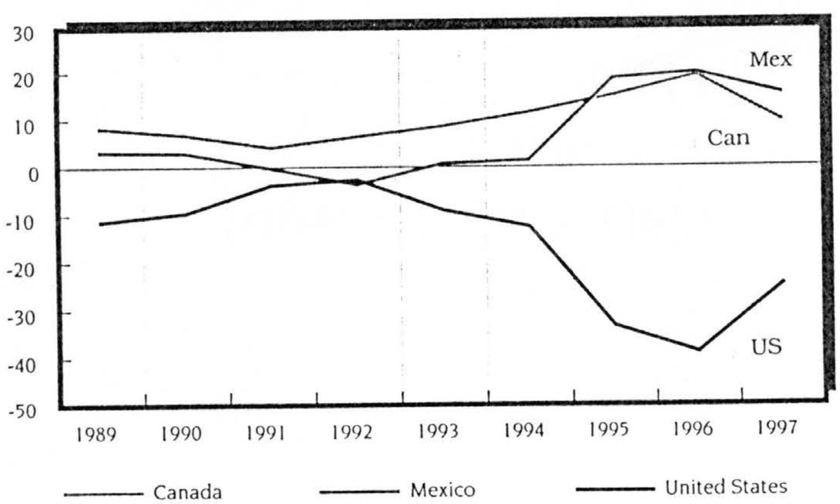
The US trade deficit within NAFTA rose from a near balance at $2.7 billion in pre-NAFTA 1992 to $39.0 billion in 1996. (It is expected to fall to about $25 billion in 1997 – See Table 1 and Figure 2).

Yet the trade deficit should not be the sole measure of NAFTA, and it is clear that the agreement has not been the primary cause of this swing. The sharp decline in the Mexican peso – from US$0.32 in 1993 to US$0.12 in late 1997 – and a milder decline in the Canadian dollar –from US$0.77 in1993 to US$0.70 in late 1997 – have completely overwhelmed

FIGURE 2

Trade Balances within NAFTA

Billion of US Dollars



Sources: US Bureau of the Census, Statistics Canada, and editors' estimates

(Cremeans: 1998, 14)

the effects of tariff reductions as the result of NAFTA. Price cuts resulting from reduced tariffs have been minuscule in comparison to the "price cuts" brought about by movements in the rates of exchange.

During the period that NAFTA has been in effect, the US economy has exhibited remarkable strength. Over the period, US real GDP grew by 8.1 per cent. US domestic demand grew by 16.6 per cent. US employment and industrial production also continued to grow strongly. US unemployment, for example, dropped from 6.9 per cent in January 1994 to 5 per cent in June 1997. The current recovery, in contrast to previous post-War expansions, has been characterized by strong rates of investment, thus helping extend the US growth cycle with low inflation. Real fixed investment (non-residential) was up 9.9 per cent in 1994, 9.5 per cent in1995 and 7.3 per cent in1996. Investment in producer's durable equipment, at 7.6 per cent of GDP in 1996, was at its highest level since the 1950s.

US net employment has increased by nearly 8.6 million jobs in NAFTA's first three years. Strong job creation in the United States in recent years has been all the more striking in that job creation has been so weak in other major industrial economies. Over 90 per cent of US job creation has also been in the private sector. A recent study by the Council of Economic Advisors (CEA) finds that approximately two-thirds of recent job growth has been in job categories paying above the medium wage.

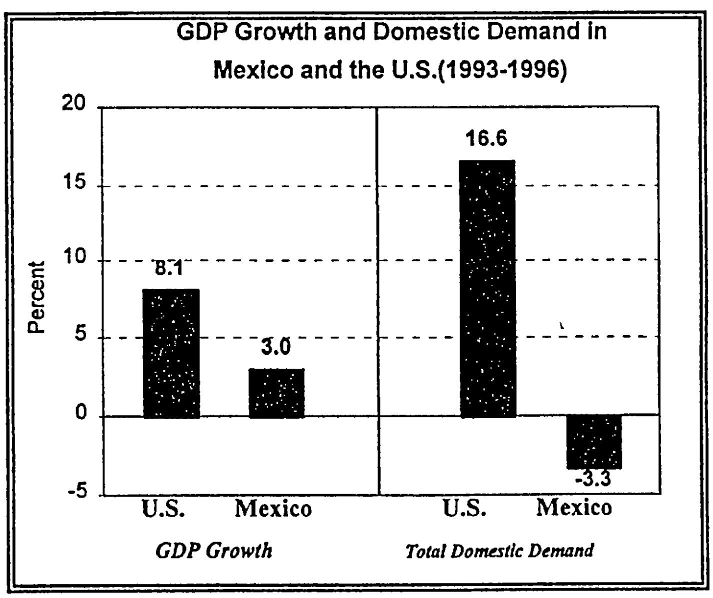
Nearly every real income measure – real hourly earnings, real weekly earnings and real compensation per hour, for example – is up moderately since 1993. To the extent that inflation is overstated, those gains are understated. And, after a 14-year-period in which US income gains were concentrated in the top half of the income distribution have increased since 1993, with the largest percentage increase for those in the lowest income quintile.

Exports have been a key driver of US growth, accounting for one-third of our overall growth since 1993, and growing more than three times faster than the overall US economy. US export growth was robust, with goods and services exports to the world up nearly 32 per cent from 1993 to a level of nearly $850 billion in 1996. Goods and services imports, reflecting the strength of the US economy were up 34 per cent between 1993 and 1996. As a result, the goods and services deficit rose from $72.3 billion in 1993 to $111.0 billion in 1996. The high level of US purchases from all sources reflects the fact that robust economic performance in the United States stimulated import demand (Cremeans: 1998, 12-15).

The NAFTA's Effect on the US Economy

The task of isolating the economic effects of NAFTA after little more than four years of operation is challenging; while Mexico's tariff reductions have been substantial, its market-opening rules are not fully phased in and we have only three years of data. The challenge is compounded by the several significant events that directly affected trade flows during the first three years of NAFTA's operation. These were: (1) the strong performance of the United States economy (2) Mexico's balance-of-payments crisis and the 1995 recession, its worst since the 1930s; and (3) implementation by the United States beginning in 1995 of MFN tariff cuts mandated by the Uruguay Round agreements. Strong growth in the United States stimulated US demand for imports from Mexico, quite aside from any specific effect of NAFTA. Mexico's recession, which was not caused by NAFTA, depressed its demand for imports from the United States. While the economy continued to grow, Mexico suffered a balance-of-payments crisis beginning in late 1994 and in 1995 endured its most severe recession since the 1930s (Figure 3).

FIGURE 3



(Executive Summary: The Presidents Report to Congress: 1997, 13)

Consumption fell by over 17 per cent in 1995; more than 1.0 million Mexicans lost their jobs (a year in which the US added 1.7 million jobs), and wages fell by more than 20 per cent in the year after the crisis began. The related depreciation of the peso acted to shift demand from US to Mexican products.

Finally, some of the 1.4 percentage point tariff reduction the United States has made under NAFTA would have been made in any event pursuant to the Uruguay Round agreement. Absent NAFTA, Mexico, on the other hand, would likely have raised its applied tariffs against the United States, as it did against other countries (Executive Summary: The Presidents Report to Congress: 1997, 11-13).

Long-Term Efficiency Benefits from NAFTA

Over the long term, the main impact of larger US-Mexican trade will be higher incomes made possible by greater efficiency and faster growth. Efficiency in both economies will be boosted by the tendency of each country to export those goods and services in which it has a comparative advantage. Faster growth will result from more intense competition among a larger number of firms in each segment of the market and from an expanded North American market that will enable each firm to realize economies of scale.

Indirect evidence on the benefits of expanded trade is provided in a study by David Walter, Chief Economist in the Office of the US Trade Representative (1992a). According to the study, US direct and indirect private-sector jobs supported by nonagricultural exports to world markets pay wages that are about 16.7 per cent higher than average nonagricultural jobs throughout the US economy. A parallel analysis by Walters for exports to Mexico (1992b) indicates that, on average, US jobs supported by nonagricultural exports to Mexico pay 12.2 per cent more than average US nonagricultural jobs. It should be noted that, in his calculations, Walters compared the average wage of export-supported employment to the average wage of all employment; Walters made no comparison to the average wage of import-dislocated employment. In terms of bilateral US-Mexico trade, there is little difference in the average wage between export-supported and imported-dislocated jobs. These calculations suggest that US gains from NAFTA will result not from a shift in the occupational composition of the US work force but rather from greater efficiency within the traded goods sector and faster growth in the two economies (Hufbauer & Schott: 1993, 23-25).

The reduction of Mexico's tariff and other barriers to US exports under NAFTA has already shown signs of encouraging market-driven coordination of production across the US-Mexican border. This is true in the auto sector, in the telecommunications equipment sector, in computers, in electronic products and in textiles and apparel. Mexico tends to compete with other low and middle-income countries for labor-intensive, basic production which is complementary with the capital-intensive, highly-skilled production in the United States. For example, in the textiles and apparel sector, the NAFTA appears to be contributing to strong growth in two-way textiles and apparel trade with Mexico. In apparel assembly, Mexico is displacing other leading producers, including China. Mexican assemblers use a much higher per centage of US fabric and components, than other assemblers thereby increasing US exports and increasing the overall level of US-produced content in US apparel imports.

The long term efficiency benefits from NAFTA to date are impressive in sectoral trade. For example US employment in the automotive sector grew by 14 per cent from1993 to 1996, including a 10.6 per cent increase in employment in the automobile assembly sector. By contrast, Mexican employment in the automotive sector dropped steadily. During the period, US imports of Mexican automotive vehicles and parts rose by $11.75 billion to a total of $22.9 billion. US exports to Mexico of automotive vehicles and parts were $8.4 billion in 1996, up from $7.5 billion in 1993. In the computer equipment sector, where Mexican imports rose by $2 billion to a total of $2.9 billion to 1996, US employment rose 9 per cent. US computer exports to Mexico in 1996 were $1.9 billion, up by $0.7 billion from 1993 (Executive Summary: The Presidents Report to Congress: 1997, 40-41).

If the critics are correct in their assumptions, NAFTA portends greater integration of the economies of Canada, the United States and Mexico. Already there are examples of integrated industries. The motor vehicle industry in Canada and the United States is integrated as a result of the Canadian-US Auto Free Trade Agreement; the Mexican-US motor vehicle industry is rapidly moving toward the same status.

CHAPTER VI

Conclusion

NAFTA has been in effect since January 1, 1994, and the data is just beginning to emerge so that the ultimate success or failure of NAFTA has yet to be determined.

NAFTA's positive achievements up to now have been significant. NAFTA has lowered tariff and non-tariff barriers and promoted regional trade and investment, has promoted economic growth in Mexico and has cemented a commitment and provided the provisions that gives the governments an opportunity to work cooperatively.

Much of the controversy over NAFTA came from the labor sector and special interest groups over the environment. Keep in mind that unskilled workers may be the affected group and not the work force as a whole. Increased trade with developing countries accounts for only about 10 to 20 percent of the changes observed in wages and income distribution in advanced economies. Conversely, 80 to 90 percent of the changes in wages and income distribution are attributable to factors other than trade with developing countries. For example, after the Cold War, the United States saw a decline in employment in the defense industries, which was not caused by trade liberalization.

Simply stated, job displacement and employment losses must be viewed in the context of the dislocation that occurs continually in modern economies due to improved technologies and domestic competition.

As societies move up the income ladder, the level of economic activity will increase. More goods and services will be produced, consumed and disposed; as incomes increase so does demand for environmental quality. Environmental issues in Mexico and Canada existed long before NAFTA was implemented. As previously stated, NAFTA is still in its infancy and it is difficult to say if the environment is better or worse. Whatever problems exist were not created by NAFTA and to expect these to be resolved in four years is unrealistic. Several institutions have been created by NAFTA to solve environmental issues throughout the continent – bilateral agreements exist between US-Mexico and US-Canada (see Appendix B).

Given the limited data available on NAFTA, have the national objectives for the United States and Mexico been realized?

The short answer is yes. Mexico needed internal economic restructuring and NAFTA provided the Mexican government a "way out" of the peso crisis and balance-of-payment fiasco. If the national objective was to pull Mexico out of these crisis' and establish economic reforms – it has succeeded. Since NAFTA, Mexico has become the 2nd largest trading partner to the United States. NAFTA was Mexico's first comprehensive regional trade agreement to cover trade in goods and services as well as investment, a regional trade agreement that has become the cornerstone of Mexico's thriving export sector. The NAFTA is not a treaty, so sovereignty only becomes an issue when national sovereignty has been diluted by government decisions that affect society. Mexico maintains freedom from external control and retains its foreign policy autonomy. NAFTA is a trade agreement with rules, provisions and dispute resolutions that binds Mexico to the US and Canada -- an asymmetrical dependence allowing for benefits that outweigh the costs of relinquishing some sovereignty.

For the United States, the primary objectives and political dimensions have to do with preservation and stability of the southern border, the need for Mexican oil, and US expansion to access new markets. In the past the US has given higher priority to stability than to democracy in Mexico. Today the reverse is true. Also, for the United States the same NAFTA rules apply. However since the US is bigger in size and economy, the advantages will be higher. Total employment growth in the US has changed any negative employment effects that NAFTA might have generated.

NAFTA does not free trade, but certainly liberalizes it. The best assessment that can be provided for the economies of the United States and Mexico based on the limited data available is that trade liberalization has been good for both countries.

The Mexican economy experienced its most severe recession in 1995. Comparing Mexico's recovery in 1996 with its recovery from the last financial crisis in 1982 (when NAFTA was not in effect), reveals that both the Mexican economy and American exports recovered more rapidly following the 1995 crisis than the 1982 crisis, in part because of the economic reforms locked in by NAFTA. Mexico's strong economic adjustment program and bilateral and multilateral financial support were also important. Following Mexico's 1982 financial crisis, Mexican output drifted down for nearly two years before rising again and did not recover to pre-crisis levels for five yeas. Although Mexican economic output dropped more quickly in 1995, it also rebounded more quickly, reaching pre-crisis peaks by the end of 1996. Similarly, following the 1982 crisis, it took Mexico 7 years to return to international capital markets, while in 1995 it took 7 months. Also in 1982, Mexico raised tariffs by 100 percent and American export to Mexico fell by half and did not recover for 7 years. In 1995 Mexico continued to implement it NFATA obligation even as it raised tariffs on import from other countries. As a result, American exports recovered in 18 months and were nearly 37 percent by the end of 1996 relative to pre-NAFTA levels, even though Mexican consumption was down 3.3 percent.

Several studies conclude that NAFTA contributed to America's economic expansion. NAFTA had a modest positive effect on US net exports, income, investment and jobs supported by exports. NAFTA boosted real exports to Mexico by $12 billion in 1996, compared to a smaller real increase in imports of $5 billion, controlling for Mexico's financial crisis. An earlier study by the Dallas Federal Reserve that NAFTA raised exports by roughly $7 billion and imports by roughly $4 billion. The relatively greater effect on exports partly reflects the fact that under NAFTA Mexico reduced its tariffs roughly 5 times more than the United States.

Since NAFTA went into effect US suppliers have seen their share of Mexico's import market grow from 69.3 percent to 75.5 percent, reflecting a 10 percentage point average over foreign suppliers and Mexico's share of American imports has risen from 6.9 percent to 9.3 percent (Executive Summary, The Presidents Report to Congress: 1997, 1-28).

In the long run, I think that the impact of NAFTA will reach beyond the Americas and will become a model for future agreements around the world. What makes NAFTA unique is that a less developed nation joined two highly developed countries as an equal partner and that all parties have benefited to some degree because of trade liberalization effected under the agreement.

Appendix A:

The Maquiladora-9802 Program: A Forerunner to NAFTA

One of the major complaints about NAFTA is that it seems to encourage the relocation of US and Canadian companies to Mexico. In reality, however, this trend has been going on for more than 20 years under Maquiladora-9802, a duty-free manufacturing and re-export program that grew out of a US customs initiative. NAFTA's main impact has been to extend duty-free trade to all industries in Mexico, which, ideally, should stimulate economic growth in non-Maquiladora areas and, concurrently, boost demand for higher value imports from the United States and Canada.

How Maquiladora Works

Under the Maquiladora program, components and raw materials are imported into Mexico from abroad without duty and held in bond by the manufacturer while further processing takes place. The resulting products are then re-exported, with only the value-added portion subject to Mexican taxes. The program was initiated by the Mexican government more than 20 years ago and has enjoyed steady support and growth since. Its name comes from the share of the flour the miller gets for grinding the grain.

The underlying idea was to give Mexico a "jump start" on industrialization by encouraging foreign companies to provide capital, build plants, and train workers for manufacturing. A large number of US, Asian and other foreign companies have taken advantage of this program to open plants, often with Mexican partners, for the assembly or other processing of products for export. Mexican workers earn their fee, or "maquiladora," by processing foreign materials. Mexican businesses gain the experience needed to open independent manufacturing facilities on their own. Foreign companies benefit from inexpensive labor working in modern, often high-tech plants. Maquiladora is rarely mentioned in discussions of NAFTA, yet the major problem many critics find with NAFTA – the encouragement it gives to relocation of US companies in Mexico –has been there all along.

Maquiladora is a Mexican program and a Mexican success, but it had earlier roots in US trade policy. The US Customs 806-807 program,[1] initiated in the early 1960s, permitted duty-free reimports of US manufactured parts and products that had not been "transformed" in the course of off-shore assembly.[2]

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[1] When the Harmonized Tariff Schedule (HTS) was introduced in 1988 re-imported components and materials were placed under code HTS 9802.00.80—hence the 806-807 program was renamed the 9802 program. Of course, its use is not limited to Maquiladora or to Mexico.

[2] The words "transformed" and "assembly" have never been precisely defined and are subject to interpretation, but the essential idea is that the exported materials are not raw materials to be changed into another material or product, but components to be put together with other parts by low or semiskilled workers.

The Maquiladora program eliminated Mexican duties on imported components, and US duties had already been eliminated on those components incorporated in off-shore assembly. The Maquiladora program was thus a step along the way to NAFTA—it required changes in both the Mexican and the US tariff rules, thereby greatly increasing trade with the two countries.

The Program's Changing Role

The program has been a development and employment engine for Mexico, although its recent exports have not kept pace with the surge in total Mexican exports since implementation of NAFTA. In 1993, the year before NAFTA took effect, more than half a million people were employed in Maquiladora industries; this figure rose to 750,000 people by 1996. Yet Maquiladora industries' share of exports declined from 42 percent of all manufactures exported in 1993 to 38 percent in 1996. A part of this decline may be attributed to changes in the rules governing Maquiladora sales: under the pre-NAFTA rules, output of Maquiladora plants could not be sold in Mexico; NAFTA rules provide for the gradual lifting of that restriction for products with high US and Canadian content.

In the early years, virtually all Maquiladora facilities were located in the frontier states immediately south of the US border, and 86 percent are still located there. However, states further south are gradually increasing their participation in the program.

Following implementation of NAFTA, employment in the Maquiladora apparel industry grew most rapidly (27.2 percent annually), moving the industry to third largest employer in 1996 from fifth in 1989. This was probably due to the substantial reduction in US tariffs on apparel at implementation of NAFTA. Tool industry employment grew at a 14.4 percent rate during 1993-96. Electric and electronics grew at 13.4 percent, and transportation equipment, at 7.7 percent. In the United States, on the other hand, employment in apparel manufacturing fell by 146,000 workers from December 1993 to March 1997, and that in tools was virtually unchanged. Yet, US electronic and other electrical and motor vehicles actually increased their employment by 100,000 workers each over the same period (Cremeans: 1998, 29-33).[3]

[3] US industry employment data from Bureau of Labor Statistics

Appendix B:

The Side Agreements

Following the US Presidential election, congressional approval of NAFTA was by no means certain. President Clinton was unable to get the tough labor and environmental agreements he wanted because neither the Mexicans nor the Canadians wanted to give up their authority over these sensitive issues. He did get two side agreements that created commissions with authority to "monitor" and "recommend," but not to enforce. These new agreements created a Commission on Environmental Cooperation (CEC) and a Commission on Labor (CLC). Ironically, these agreements were viewed as "tame" by many of those Clinton wanted to persuade, while a few NAFTA supporters grumbled that the commissions weakened US sovereignty. Whether because of or in spite of the side agreements, NAFTA was approved by the US Congress in November 1993.

In the years since implementation, both commissions have been active and have assisted in trilateral cooperation outside the scope of the agreement itself. The CLC's three commissioners have met several times, and the CLC recently published its first report, *North American Labor Markets: A Comparative Profile."*

The Commission for Environmental Cooperation has been active also and has received a number of "enforcement petitions" to be investigated. Environmental organizations opposed NAFTA almost unanimously at the beginning, and organized opposition re-emerged when fast-track legislation was submitted to Congress in September 1997. However, the creation of CEC did reduce contention a bit and the mechanism of the CEC has actually been used in several cases to bring attention to environmental problems.

In short, the side agreements have proved to be less effective than their supporters hoped and more useful than their critics feared (Cremeans: 1998, 6).

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