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INFORMATION NOTE

NORTH AMERICAN FREE TRADE AGREEMENT

(NAFTA)

(presented by the Commission)

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SUMMARY AND CONCLUSIONS

The North American Free Trade Agreement is scheduled to come into force on 1 January 1994. It is unique in that it will liberalise trade between two highly developed and wealthy countries of very disparate size - the US and Canada - and a third partner, at a very different stage of development, whose per capita income is estimated at about one eighth that of its richer partners and of whom the population is expected to reach 100 million by the end of this century. The NAFTA represents a model of regional integration differing substantially from any European arrangement, and based on the hypothesis that free trade is a sufficient basis for economic convergence. The effects of the NAFTA on its participants, on the Community and on other non-members fall into three categories: political, trade and investment.

The implications for the US and Canada in terms of their bilateral relationship, and bilateral trade and investment flows, can be expected to be minor; significant adjustments have already taken place between them following the entry into force of the US/Canada Free Trade Agreement in 1989. With regard to Mexico, the US is overwhelmingly the major trading and investment partner of that country and can clearly expect to expand both these facets in the context of the NAFTA. Canada/Mexico trade and investment flows are tiny: there is scope for them to grow, but this growth is not expected to impact more than marginally on their economies.

Similarly, the Community's political, trade and investment relations with Canada and the US are not expected to be affected significantly by the NAFTA in the short term. In the longer term it is not excluded that the Community's exports may suffer some displacement on the US and Canadian markets, but a considerable evolution in the Mexican structure of production and trade is likely to take place before this effect is felt.

In the meantime, however, the Community expects its political relationship with Mexico to be affected by Mexico's participation in the NAFTA. By this participation, Mexico is expected to gradually move towards a standard of economic development which more closely resembles that of its partners. This will mean that it will similarly achieve more equality in its relationship with the Community. That relationship has been and is being fostered by both sides. As the NAFTA draws Mexico more closely into the North American orbit, Mexico's relationship with the Community may gain importance as a counterweight.

As Mexico's second largest trading partner after the US, the Community has already benefited from the increased openness and growth in the Mexican economy over the past few years, although Mexico still only represents 1.14% of total Community exports. Some displacement of Community exports by American products can be expected as tariffs between the partners disappear but it is expected that the dynamism generated and reinforced in Mexico by the NAFTA will permit a considerable further expansion of trade with the Community.

By achieving duty free access to one of the largest and richest markets in the world, Mexico will become one of the most attractive investment destinations for third countries, including the Community. The Community is already Mexico's second largest source of direct foreign investment. By locking the Mexican economy into a market orientated regional grouping, the NAFTA gives investors considerable security. The Community is therefore likely to continue its trend towards increased direct investment in Mexico.

The Community does perceive potential negative impacts on its interests arising from the NAFTA, and in some cases can and should take steps to minimize these. Firstly, where the external tariffs of the three parties to NAFTA are high, and the corresponding preference between NAFTA partners is consequently greatest, the Community can endeavour to negotiate reductions in those external tariffs. Secondly, given that many of the non-tariff benefits of the NAFTA will be multilateralised on completion of the Uruguay Round negotiations, the NAFTA represents an added incentive for the Community to pursue its current efforts to

conclude that agreement. Thirdly, in certain specific sectors (such as textiles) where quotas and exemptions will be reviewed after some years the Community should support and reinforce the efforts of those NAFTA interests militating in favour of a less trade distorting situation. Fourthly, in any case where a NAFTA partner differentiates between enterprises established in the NAFTA area, and owned by NAFTA nationals on the one hand, or by non-NAFTA nationals such as members of the Community on the other (for example, as is the case in Canada regarding investment screening), the Community should bring pressure to bear to ensure that Community enterprises duly established in North America are not discriminated against - just as foreign companies duly established in the Community are treated exactly as Community owned companies. Finally, where the Community perceives that in the agreement, or in its implementing legislation, trade provisions appear to create a situation towards non-NAFTA members which is more restrictive than the pre-NAFTA situation, the Community should actively pursue the issues in the GATT context.

In summary, therefore, and notwithstanding some displacement of certain exports of the Community to the participants of the NAFTA, the impact of the NAFTA on the Community can be expected to be felt most strongly in terms of its political and economic relationship with Mexico; that impact is expected to be globally positive.

I. INTRODUCTION

The North American Free Trade Agreement (NAFTA) was concluded between negotiators from the US, Canada and Mexico in early August 1992. It was signed by Presidents Bush and Salinas and Prime Minister Mulroney on 17 December 1992 and, if ratified, should come into force on 1 January 1994. The possible extension of NAFTA to include other partners is not to be excluded in the future. President Bush offered in June 1990 to get more nations from South America to join the US in a free trade area. In Asia, Korea was the most interested country. It has been pointed out by authoritative sources that the conditions of accession to NAFTA were deliberately drafted in rather vague terms, with the purpose of leaving future developments in the hands of founder NAFTA members.

The NAFTA agreement has been negotiated well ahead of the UR and appears to have precedence on the US political agenda over other trade policy issues in particular the UR for which the President has now proposed to renew the Fast Track procedure. The ratification process of NAFTA could well have considerable impact on the attitude which the US takes vis a vis the UR negotiations as well as their readiness to make concessions in sensitive negotiating areas, such as textiles. In this respect it is worth noting that the US textile lobby has recently started to make clear links between NAFTA and the UR by seeking changes of the Draft Final Act. They consider that they have already made enough concessions under the NAFTA. These developments would be particularly regrettable, because it can generally be assumed that the economy and trade effects of a positive outcome of the UR should outweigh by far the effects of the NAFTA agreement.

The motivation for entering into a North American Free Trade Agreement encompassed both economic and political factors. Clearly each participant to a free trade agreement enters into it in order to stimulate trade between the partners through the elimination of tariffs and non-tariff barriers. The objective is to increase overall economic wellbeing through a more rational allocation of resources and increased competitivity. Apart from that general objective, however, each participant normally has more specific objectives and in the case of the NAFTA participants these more specific objectives were highly diverse.

Mexico sought a NAFTA because of the current government's policy of opening its economy in order to encourage investment and move towards a higher standard of living. In this respect, it is interesting to note that in a recent speech on regional agreements, Mr. Dunkel, Director General of GATT, said that in his view, a country which has made the fundamental choice to open up to the world can show very good sense in pursuing regional trade liberalisation: this offers economies of scale, opportunities for specialisation, a magnet for foreign investment, a stronger collective voice in the world's economic councils, and often important political gains as well. These objectives could well be a summary of what Mexico has sought in negotiating the NAFTA.

To ratify the NAFTA, President Salinas needs only Senate approval: his party holds 61 of the 64 seats.

There has been little opposition in Mexico to the NAFTA. Although it is clear that there will be adjustment problems, the NAFTA is widely seen as advantageous to the country and of benefit to the majority of the population. Those opponents who have voiced concern cite fears of an

increase of US influence and loss of Mexican sovereignty. The suggestion is also made that in a country in which wealth is extremely unevenly divided, the NAFTA will benefit the rich.

The US has changed its approach towards regional trade groupings, influenced in part by what it perceives as a broad trend towards such arrangements (especially, but not only, in Europe) as well, perhaps, as by the slow progress in the Uruguay Round negotiations. This new approach was seen most clearly in the dynamic attitude taken by the Bush administration to the NAFTA negotiations and its clearly stated willingness to consider extending that agreement to atone Latin American countries.

More specifically regarding Mexico, the US interest was to support the efforts of Mexico's President Salinas; to consolidate the advantages gained from Mexico's autonomous reduction in barriers to trade and investment; and to encourage economic growth in the region, in order to diminish the illegal immigration from Mexico. In addition, given the high proportion of Mexican income spent on imports from the US, higher economic growth in Mexico is clearly in the interests of the US.

In the US, the implementing legislation is being prepared and when this goes to Congress, it must be agreed or rejected 90 session days thereafter; this would imply approval or rejection by mid-1993. The Agreement has been presented to Congress already, well before the expiry of the current "fast track" authority (which runs out at the beginning of March and under which Congress can accept or reject but cannot change an agreement).

President Clinton has expressed himself as favourable to the NAFTA. In his meeting with President Salinas on 8 January 1993, however, he reiterated his intention to negotiate additional protocols or supplementary agreements, covering in particular environmental and labour issues, as well as protection against import surges.

It is not yet clear what content such protocols should have. Certain members of Congress emphasise that regarding the environment, better enforcement of Mexican law and substantial clean-up projects will be sought. Mexico has already rejected any form of US interference in how it applies its laws - and any suggestion of US extraterritoriality would be resisted strongly by Mexico, as well as constituting a cause for concern for other partners, such as the Community. As for the possibility of clean-up projects, some members of Congress have suggested that this, as well as worker retraining, should be funded by a transaction tax. This is fiercely rejected by business interests domestically. Any such tax would also require careful Community monitoring both for its GATT compatibility and to ensure that transactions which do not benefit from NAFTA preferences would be exempted. Regarding labour issues, Congress argues again for more effective implementation of Mexican laws (potential extraterritoriality), and seeks retraining programmes to be financed by the transaction tax. Finally, on import surges, it is unclear what type of protocol might be sought, since protection is already foreseen in the NAFTA against this situation.

There is a considerable number of interest groups opposed to the NAFTA. These include organised labour, which fears an outflow of investment to Mexico and declining wage levels in the US; environmental groups express the concern that environmental standards will be lowered in the US to

meet competition from less strictly regulated industry in Mexico; various agricultural sectors fear Mexican competition; the film and media industry object to the general exemption to NAFTA rules granted for Canadian cultural industries; and there are others. Now that President Clinton has made it clear that he does not intend to renegotiate the deal but rather add to it, the question arises whether the various interests outlined above can muster adequate support in Congress to delay passage of the NAFTA. As at end February, the majority of commentators consider that NAFTA is likely to pass in Congress; but opposition is becoming more vocal. It is not clear, moreover how President Clinton's intention to negotiate the protocols referred to previously will impact upon the timetable for presentation of the implementation legislation to Congress and its ratification, but US Trade Representative Kantor assured the Senate (on 9 March 1993) that he will not seek a vote on the NAFTA implementing legislation until his negotiations "result in comprehensive, enforceable agreements".

Canada was the most reluctant participant. The original Canadian motive for a bilateral free trade agreement with the US, which led to the Free Trade Agreement which entered into force in 1989, was to protect itself from what it perceived as US harassment. If the US had then entered into further bilateral agreements with Mexico and other Central and Latin American states, this could have led to the dilution of the Canadian special position on the US market without any compensating benefit of access to other third countries. Canada, therefore, saw its interest to avoid the strengthening of the position of the US which would have resulted from a so-called "hub and spokes" arrangement (under which the US would have free trade agreements with many countries but those countries would not have free trade arrangements with each other).

In Canada, the implementing legislation, when prepared, must go through the Committee stages in both the House and the Senate and will then be voted in Parliament, where his large Progressive Conservative majority will ensure approval.

Public objection to the NAFTA is, thus far, considerably more muted than the opposition which faced the US/Canada Free Trade Agreement in the course of 1988. At that time, the two main political parties in opposition and a broad coalition of interests ranging from organised labour through minority groups (women, Indians) to ardent nationalists objected to the FTA. An election was effectively fought on the issue and the government (and the FTA) won by a narrow margin. It is clear that the effects of the NAFTA on the Canadian economy will be considerably more marginal than the effects of the FTA, and this should, at first sight, ensure relatively easy passage of the NAFTA. However, feelings about the US/Canada FTA are still extremely divided, and considerably heated; the coalition of interests against the FTA claim that experience has born out their thesis and that the FTA has been bad for Canada - by analogy, the NAFTA will be worse. Supporters of the FTA claim that the opposite is true.

The main specific objections voiced in Canada to the NAFTA so far relate to the risk of declining wages and an outflow of investment (as in the US case), the environmental problem, the automobile sector and textiles. For automobiles, the Auto Pact which since 1965 has governed trade in this sector with the US and which has been hugely beneficial to Canada had required a 60% Canadian content; the NAFTA, on the other hand,

requires a 62.5% North American content. For textiles, strict rules of origin are expected to be detrimental to Canada's important garment industry, which depends to a large extent on imported textiles.

The Progressive Conservative government of Prime Minister Mulroney has currently a very low level of support among the population, according to the polls. The Government must face an election by Autumn 1993. Should the opposition parties decide to run on an anti-NAFTA platform, it is not excluded (if not very likely) that Canada would in the end seek to renegotiate the NAFTA.

II. BASIC DATA

The North American Free Trade Agreement will create the second largest free trade agreement in the world after the European Economic Area (EEA). The population of the NAFTA (some 360 million) is slightly less than that of the EEA (375 million, without Switzerland). The Gross National Product of the 18 countries participating in the EEA is estimated at $US 7 trillion, compared to the GNP of NAFTA - $US 6.2 trillion.

The rules of the NAFTA are in some cases comparable to the EEA. Both go further than traditional free trade agreements, but the EEA goes considerably further than the NAFTA. Not only does it eliminate barriers on substantially all intra-EEA trade, but goes further and eliminates also barriers on all movement of labour and capital. After a transitional period the market in services will be free and there will be no screening of investments. In the EEA the closer integration foreseen, including in the area of competition policy, means that neither anti-dumping nor countervailing duties will be applied by any member of the EEA against another. In the NAFTA, on the other hand, investments screening remains in many cases; the free trade in services is subject to the maintenance of most of the existing limitations; and anti-dumping and countervailing duties can still be applied, albeit within the context of an elaborate dispute settlement mechanism.

However, any comparison between the EEA and the NAFTA is necessarily very superficial because the defining characteristics of the partners are so different. In marked contrast to the EEA, the NAFTA is a partnership of two highly developed and wealthy countries with a third developing country.

The size of populations of the participants ranges from 250 million in the US to 85 million in Mexico and 27 million in Canada. Whereas the US and Canada enjoy per capita income levels of $US 25,000-30,000, the per capita income in Mexico is recently estimated to have increased significantly to $US 3,600. In fact, with one third Mexico's population, Canada's gross domestic product is almost three times that of Mexico. Furthermore, the uneven distribution of wealth in Mexico means that the average family income there is still only about one tenth that of its North American partners.

Wage levels in Mexico, at just $US 2/hour, are very significantly below US and Canadian levels.

Table 1

Hourly manufacturing compensation costs for production workers
US$ / hour

	1985	1989	1990	1991
US	13.01	14.31	14.88	15.45
Canada	10.80	14.81	16.02	17.31
Mexico	1.60	1.59	1.80	2.17

% Change in $US / hour costs

	1985-88	1989	1990	1991
US	+ 2.3	+ 2.9	+ 4.0	+ 3.8
Canada	+ 7.7	+ 9.6	+ 8.2	+ 8.1
Mexico	- 6.2	+20.5	+13.2	+20.6

It is clear that Mexican wage costs are rising very much faster than those in the US and Canada. It is also suggested that much of the difference in wage costs is balanced by lower productivity in Mexico. Nevertheless, the wage cost advantage in Mexico is considered to be one of the major factors encouraging the recent inflow of foreign direct investment into Mexico (see Section III below).

Another area in which the US and Canada enjoy similar levels of wealth and productivity, and Mexico is in a radically different situation, is that of agriculture. Agriculture employs 23% of economically active Mexicans, but represents only 7% of gross domestic product. In spite of potentially fertile land, and a favourable climate, Mexico has become a net importer of food since 1989. The cause of this situation lies mainly in antiquated land laws, which are now being changed. Further, under the NAFTA, tariffs and other barriers between Mexico and the US will be phased out and internal prices will be reduced to international levels. This is likely to make several million small corn and other producers non-viable; income payments are expected to help cushion the inevitable flow from the land but will clearly not prevent it.

The foregoing data gives some indication of the differences between the US and Canada, on the one hand, and Mexico on the other, as they prepare for the NAFTA.

With regard to trade within the future NAFTA region, a very significant increase in this intra-regional trade has already taken place over the past ten years with the total rising from US$ 110 billion in 1980 to US$ 235 billion in 1990. The following table shows export trade between the three NAFTA partners in 1989.

Table 2

Intra-NAFTA trade, 1989
US$ billion

Exports from	to	US	Canada	Mexico	Others
US		-	78	25.0	260
Canada		85	-	0.5	35.5
Mexico		28	1.5	-	4.6

Both Canada and Mexico send 75-85% of their exports to the US and import approximately 70% of all imports from that source. Canadian/Mexican trade is very tiny, and although the effects of the prospective agreement are already being felt in the increased level of interest being shown in Mexico by Canada and vice-versa, the effects of the projected increase in bilateral trade on the two economies, and on their third country trading partners, is expected to be insignificant, compared to the effects on Mexico of opening up its markets even further to the US.

III. EFFECTS OF NAFTA

Given the relative sizes of the three economies participating in the NAFTA, it is obvious that the US will, in a certain sense, be the least affected in global terms. US exports to Canada are significant - 21% of total exports - but the NAFTA does not expand on the FTA in a manner which would lead to major changes in US/Canadian trade. US exports to Mexico represent 7% of total US exports; the US expects, probably correctly, a very major increase in these exports but even this is unlikely to change the structure of the US economy, except in a few limited sectors. Clearly the effect of a free trade agreement with a major trade partner is always most significant for the smaller partner.

It would appear likely that Canada will undergo considerably less change as a result of the NAFTA than that provoked by its US/Canada FTA. Four years ago the FTA came into force. It is instructive to have a brief look at the apparent results of that Agreement.

In the four years since the FTA came into force Canada has increased its exports to the US and marginally increased its share of the US market. The proportion of total Canadian exports has remained more or less constant at 77%. However, in the same period the Canadian dollar appreciated by nearly 20% compared to the US dollar (although it has fallen back in the last six months), and the US has suffered a major recession. Supporters of the FTA argue that these latter two factors would have had a very negative impact on Canadian exports to the US in the absence of the FTA; opponents of the FTA point to the number of job losses in Canada over the past few years through a difficult restructuring of industry and claim that no benefits have been felt in the life of the ordinary Canadian.

Irrespective of the final judgement, it is clear that the Canadian experience over the past four years cannot in any way serve as an indication of what Mexico can expect.

For Mexico the conclusion of the NAFTA indicates a willingness and a possibility to enter into a completely different economic order, dominated by market orientation. Economic reform started with Mexico's accession to the GATT in 1986 and has been vigorously pursued by President Salinas since his election in 1988. This has already started to change the face of the Mexican economy. Per capita income has increased from some $US 2.000/head to nearly $US 4.000 and it is clearly Mexico's ambition to achieve a standard of living comparable to its

partners, which would involve a sixfold increase in income. However, these developments must take place in a country where wealth is currently unevenly distributed and the social deficit is significant.

Since 1986, the Mexican economy is no longer driven by an effort at import substitution but by the desire for export-led growth. Tariffs, import quotas and other trade barriers have been slashed or eliminated. Major state-run companies have been privatised. Foreign direct investment has been encouraged (and has increased from $US 14.6 billion in 1985 to $US 33 billion in 1991), of which over 20% originates in Western Europe.

Table 3

Cumulative foreign direct investment in Mexico

Year	Total $ mio.	US %	Germany %	UK %	Japan %	France %	Switzerland %
1980	8.459	69	8	3	6	1	6
1985	14.629	67	8	3	6	2	5
1991	33.874	63	6	6	5	4	4

In the five years to 1991, US exports to Mexico have increased very significantly, as have Community exports. As is normal under these circumstances, imports into Mexico have increased much faster than exports from Mexico.

Table 4

Trade with Mexico (main partners
bio. ECU

	EXPORTS to Mexico			IMPORTS from Mexico		
from	US	EC	Japan	US	EC	Japan
1970	1.704	515	94	1.219	163	151
1985	17.552	2.739	1.303	25.360	5.525	2.450
1991	26.747	4.734	2.274	25.636	2.962	1.405

The resulting current account deficit has grown significantly from US$ 11.1 billion in 1991 to US$ 18.7 billion in 1992. Imports are estimated to be approximately 66% for consumer goods, with the rest for investment. This deficit has been balanced by the increase in funds flowing in for investment, referred to above.

For the first few years of the NAFTA, this trend may be expected to continue, presumably with an increased emphasis on capital goods as Mexico establishes its infrastructure and as its industry adjusts to new competitive pressures. But the longer-term outlook for Mexico is one of dynamic growth. A vital component of that growth will be the expected emergence of a large middle class, in the context of a fast growing population with a concomitant rise in consumer demand.

The political effects of the NAFTA are even more difficult to assess at this point. When this Agreement is ratified, it will undoubtedly signal a sea change in the relationship between Mexico and its North American

partners; this new relationship will no longer be comparable to the relations of the other Latin American countries with their large Northern neighbours. This could clearly have implications for the Community's own relationship with Mexico.

Furthermore, the NAFTA contains an accession clause which opens the possibility of membership to any other third countries who are acceptable to the three original participants. It is expected that Latin American countries will seek membership - indeed, discussions with Chile have already started. The political implications of a free trade area covering the Americas in their entirety must also be assessed.

The trade effects of the NAFTA on third countries, and on the Community in particular will depend, to a considerable extent, on the degree to which the trade creating effects of the NAFTA (in particular due to the new dynamism in Mexico) outweigh the trade diverting effects which are the natural result of preferences accorded between the partners and the desire to ensure that only the partners to the agreement benefit from those preferences. This natural trade diversion may, however, be exaggerated in certain sectors by excessively severe preferential rules of origin (see Section V). However, if the NAFTA achieves the objectives of its participants and in particular of Mexico, the demand generated by a growing population with a standard of living which is rising rapidly from a very low base should benefit all NAFTA trade partners, and not just the participants.

The success or failure of the Uruguay Round will also be a major determinant of the effects of the NAFTA on non-members because much of the NAFTA is comparable to agreements which would come into force under that Round (in areas such as services and intellectual property). If the Uruguay Round is successful, many of the preferences granted by NAFTA partners to each other would in effect become MFN, or applicable to all GATT members.

Finally, particularly for the Community, the effects of the NAFTA in the investment area are crucial: it is clear that the NAFTA facilitates investment from the US and Canada in the fast developing Mexican economy. It is also clear that Canada maintains more severe investment screening thresholds in the NAFTA not only towards non-NAFTA members but also towards third country enterprises duly established in North America but not wholly owned by North American nationals - a situation unacceptable to the Community. However, one of the reasons that Mexico engaged in the NAFTA negotiations, and that Canada also participated fully, was to increase their attractiveness as investment destinations. It is therefore in the interests of Mexico and Canada, as well as the United States, not to make investment by non-members such as the Community more difficult.

IV. REACTIONS TO THE NAFTA

The successful conclusion of the negotiations leading to the NAFTA met with varied responses throughout the world.

Central and Latin American countries as well as participants in the Caribbean Basin Initiative have expressed deep concern that the preferences granted to Mexico will necessarily give Mexico enormous advantages in sectors of vital importance to their economies, although these disadvantages will be mitigated by Latin America's relatively generous treatment by the US under the GSP system. For most of those

countries, the US is to an overwhelming extent their most important export market. They have expressed serious concern that in particular for agricultural exports, textiles, leather and parts and components, they will lose market share to the benefit of Mexico and with serious effects on their economies. They further fear diversion of much needed investment funds to Mexico; 70% of all US foreign direct investment in developing countries has tended to be in Latin America with Brazil leading Mexico in the past as the first and second destinations.

Asian countries have expressed similar fears regarding trade competition from Mexico and investment fund diversion, referring in particular to those important investment flows which are directed systematically to low cost labour countries with access to the US market. Asian concerns also relate to a perceived risk of a "fortress North America". This perception is heightened by the severity of rules of origin in the NAFTA for certain sectors (textiles, automobiles), sectors of major importance to those countries.

An analysis of the possible effects of the NAFTA on Australia drew the conclusion that certain agricultural exports such as beef, fruit and vegetables and sugar, could suffer from trade diversion as could some motor vehicle parts and other manufactured products. This analysis also suggested the risk of negative indirect effects in terms of supplying raw material inputs such as coal, metals, components, wool and cotton, to Asia if Mexico (and subsequently other Latin American countries) benefit from preferential treatment over Asia in textiles, clothing and footwear, consumer electronics and light manufacturing. The example was given of a decline in automotive component exports from Australia to Japan if US imports of motor vehicles were diverted from Japan to Mexico.

The Community is in favour, as a matter of principle, of all free trade agreements which respect the pertinent GATT rules. The Community is, of course, aware that its exports may face tougher competition on the US and Canadian markets when the NAFTA enters into force, in sectors where North American tariffs are high and Mexico will have a commensurate benefit. Similarly, the expected growth in the Mexican market is likely to be to the advantage, first and foremost, of the US and Canada. However, such trade diversion will, in principle, be compensated by trade creation through the dynamism normally created by a free trade agreement.

In the light of GATT rules concerning the formation of free trade agreements (Article XXIV of the General Agreement on Tariffs and Trade) such trade diversion, if it occurs, is considered to be a natural consequence of a free trade agreement and not to give any trade partner (such as the Community in this case) a right to compensation[1]. In particular, Article XXIV.5 provides that duties and other trade regulations governing trade with non-participating countries should be no more restrictive after the creation of a free trade agreement than they were before it came into being. The assessment of the NAFTA in this light will take place in the GATT. Furthermore, the Understanding in the Uruguay Round on the interpretation of Article XXIV provides the

(1) Article XXIV only foresees the right to compensation where customs unions are created, leading to an increase in tariffs in the partner/partners in the union which had lower tariffs than the final common customs tariff.

possibility to invoke the GATT dispute settlement mechanism with respect to any matter arising from the application of a free trade agreement (or indeed of a customs union).

In the meantime and in the absence of the legislative texts implementing the NAFTA, an examination of the Agreement has brought to light a number of aspects of actual or potential concern to the Community. These aspects are summarised in Section V below.

V MAIN COMMUNITY CONCERNS REGARDING NAFTA

The elimination of tariffs between NAFTA partners will affect Community exports most in areas where tariffs remain high towards third countries. To the extent that tariffs are reduced in the Uruguay Round, the impact of NAFTA preferences on the Community and other third countries will of course be diminished. Given that Canada and Mexico already send 75% of their exports to the US, and in light of relative tariff levels at the start of operation of the NAFTA, tariff reductions are likely in the shorter term to result in an increase of US exports to Mexico. This, therefore, is the market in which the community may face most increased competition through NAFTA tariff preferences.

In the areas of financial services, insurance and investment, the major problem raised is the possibility that in these sectors the benefits of the NAFTA be limited to companies which are majority owned/controlled by NAFTA nationals. This is contrary to Community practice towards foreign-owned firms established in the Community and in the European Economic Area and would constitute a very important and unjustified discrimination against Community owned/controlled subsidiaries in North America. Canada, for example, limits certain NAFTA related advantages in the financial services sector to firms owned or controlled by NAFTA nationals (although it has offered to limit this restriction within the context of a successful conclusion of the GATS - General Agreement on Trade in Services).

With regard to investment, it is not clear to what extent performance requirements, which are eliminated for NAFTA partners, are eliminated also for non-NAFTA partners. What is clear is that investment screening is still applicable to third countries. However, as mentioned above, it is considered unlikely that Mexico or indeed its two NAFTA partners will seek to raise obstacles against foreign investment (except perhaps in specific, sensitive sectors).

The area of services is one in which a Uruguay Round agreement (General Agreement on Trade in Services) will ensure that most of the benefits of the NAFTA will be multilateralised; the absence of such multilateralism could lead to considerable trade diversion in the services sector, to the detriment of Community trade in services and particularly to its potential trade in services with Mexico.

Rules of origin at least for cars and textiles are more restrictive than in the FTA (or in the EEA). Although not contrary to GATT, this is clearly against the interests of exporters of car parts to Canada and Mexico (whose car exports are almost entirely directed to the US). For textiles, stricter rules of origin are somewhat compensated by increased exemptions to those rules; but Community industry does expect to suffer loss of market share, particularly in Canada which habitually imported yarns and fabrics to produce garments for export to the US. In this respect it is encouraging to note that Canada has announced a unilateral

decrease in its external tariff on textiles - this move is in response to Canadian apparel manufacturers, and will benefit the Community and other suppliers of textiles to Canada.

In agriculture, Canada chose to maintain its supply management for dairy, poultry and eggs and has therefore a bilateral agreement with Mexico excluding those sectors. The US/Mexico bilateral deal in agriculture appears to give major advantages to both parties. In the Mexican market Community exports of dairy products, sugar and meat could suffer from competition from the US.

In particular for sugar, a provision of the NAFTA states that six years after implementation, Mexican protection in the sugar sector shall be equivalent to US protection. Since the US sugar market is one of the most protected in the world, the Community is concerned that this provision may mean an increase in protection for sugar in Mexico.

One Article in the agricultural chapter of the NAFTA refers specifically to export subsidies, and allows for a signatory (say Mexico) to be prompted by another signatory (say the US) into agreeing to specific measures "... to counter the effect of any such subsidized imports". No reference is made in the Article to the need for such measures to respect the relevant provisions of the GATT.

As in the FTA, it is proposed in the NAFTA that dispute settlement on an issue which is GATT-related may take place either under the procedures of the NAFTA or in the GATT (and indeed, there are additional provisions which would tend to lead to greater use of the NAFTA procedures). This would raise a potential problem of conflicting interpretations of GATT provisions; procedural conflicts could also arise (for example, recently an FTA member delayed the adoption of a GATT Panel report until the FTA had ruled on the same issue). For these reasons, the interests of GATT Contracting Parties could be affected.

Customs user fees: the NAFTA provides that these US fees should not be charged on NAFTA origin products. The GATT provides that such fees shall be limited to the approximate cost of the services rendered. The Community will have to ensure that fees which are not levied on NAFTA trade shall not be recuperated by an increase in fees for third country trade.

In the section dealing with intellectual property, NAFTA provides for so-called "pipeline protection" for pharmaceutical and agrochemical inventions. This clause creates an obligation for Mexico to grant for US and Canadian product inventions for which at present no product patents are available under Mexican law, a special patent protection for the remainder of the patent term in the US or Canada. It is obvious that this provision creates a potentially serious discrimination against Community patent right holders.

SUMMARY OF CONTENTS OF THE NAFTA

The following is a summary of the North American Free Trade Agreement between the United States, Canada and Mexico.

Chapter 1: Objectives

To formally establish a free trade area between the United States,Canada and Mexico that is consistent with the General Agreement on Tariffs and Trade. To eliminate barriers to trade, promote conditions of fair competition and increase investment opportunities. The Agreement establishes that the NAFTA takes priority over other agreements to the extent there is any conflict.

Chapter 2: Definitions

This chapter defines words and terms particular to the Agreement.

Chapter 3: National Treatment and Market Access for Goods

Each Party shall accord national treatment to the goods of another Party (in accordance with Article III of GATT). Customs Duties will either be eliminated or phased out in five or ten years, and for certain sensitive items (Category C+), shall be removed in fifteen equal stages beginning from 1 January 1994 when the Agreement comes into force.

Annex 300-A: Trade and Investment in the Automotive Sector

The Parties have agreed to progressively eliminate barriers to trade between them in this sector, but have simultaneously tightened the Rules of Origin which will affect third country exports.(cf. Chapter 4 Rules of Origin).

Annex 300-B: Textile and Apparel Goods

This relates to trade in fibres, yarns, fabrics and clothing in the North American Market. In scope, the NAFTA takes precedence over any other existing or future agreement applicable to trade in textile or apparel goods including the Multi-Fibre Agreement.

Chapter 4: Rules of Origin

The basic principles for determining the NAFTA origin of a product are the same as those applied by the Community in the EEA context. To calculate the value added the NAFTA provides for both the Transaction Value Method and the Net Cost Method. For motor vehicles however, the Net Cost method is obligatory. The North American content for motor vehicles has been set at 62.5% compared to only 50% in the US-Canada Free Trade Agreement (although the method of calculation has changed so that a direct comparison is not possible).

Chapter 5: Customs Procedures

A Certificate of Origin shall be introduced certifying that goods originate in one of the three Parties to the Agreement. A Certificate shall not be required for a commercial good whose value does not exceed

$US 1,000. This chapter also includes rules for the Administration and Enforcement , Origin Verifications, Penalties, Review and Appeals and general definitions.

Chapter 6: Energy and Basic Petrochemicals

The specific aspects of the US-Canada energy trade, as set out in the Energy chapter of the FTA, will continue to apply between the two countries. The NAFTA provisions incorporate the GATT disciplines.
With regard to National Security Measures, no party may adopt or maintain a measure restricting imports of an energy or basic petrochemical good from another Party. Mexico, however, has secured an exemption from this clause and is free from any obligations in this area.

Chapter 7: Agriculture and Sanitary and Phytosanitary Measures

The rules of the Canada/US FTA on tariff and non-tariff barriers will continue to apply to agricultural trade between the two countries. The three NAFTA members have agreed to eliminate all tariff and non-tariff barriers on their agricultural trade over a period of fifteen years, - with the exception of dairy products including eggs, poultry and sugar.

Each Party may adopt Sanitary and Phytosanitary measures necessary for the protection of human, animal or plant life including a measure more stringent than an international standard, guideline or recommendation.

Chapter 8: Emergency Action

If imports from one NAFTA member causes or threatens to cause serious injury to a domestic industry, that NAFTA country may take a safeguard action that temporarily suspends the agreed duty elimination or re-establishes the pre-NAFTA rate of duty.

Chapter 9: Technical Barriers to Trade / Standards-Related Measures

This chapter establishes the right to take standards-related measures to prohibit the importation of a good of another party that fails to comply with the requirements of the importing Party.

Although there is a general obligation to treat the other Parties regulations as equivalent, the burden of proof of equivalence remains on the exporting country.

Chapter 10: Government Procurement

The chapter on government procurement goes beyond the existing GATT Agreement on Government Procurement to which the US and Canada (but not Mexico) are parties. It is strictly limited to undertakings established in the territories of the three NAFTA members.

Chapter 11: Investment

Each country shall treat NAFTA investors and their investments no less favourably than its own investors (i.e. National Treatment) and investors of third countries (i.e. MFN Treatment).

Chapter 12: Cross-Border Trade In Services

The cross-border trade in services provisions establishes a set of basic rules and obligations to facilitate trade between the three countries. Each Party shall accord to service providers of another Party treatment no less favourable than that it accords to its own service providers.

The definition of cross-border services includes movement of natural persons. Under the Agreement, no Party may require a service provider of another Party to establish or maintain a representative office or to be resident in its territory as a condition for the cross-border provision of a service. The conditions of this chapter do not apply to Financial Services as defined in chapter 14.

Chapter 13: Telecommunications

Each Party shall have access to and use of any public telecommunications transport network or service (including private-leased circuits) offered in its territory or across its borders.

These provisions only relate to enhanced services (or value-added services). The networks themselves are outside the scope of the Agreement.

Chapter 14: Financial Services

There is a general recognition of principle allowing the investor of one Party to establish a financial institution in the territory of another NAFTA Party.

Canada will eliminate its restrictions on foreign ownership of Canadian financial institutions and on total domestic assets of foreign bank subsidiaries in Canada only vis-à-vis companies controlled by US or Mexican nationals (excluding US and Mexican subsidiaries of Community financial institutions).

Chapter 15: Competition Policy, Monopolies and State Enterprises

Each Party will adopt or maintain measures against anti-competitive business practices and will cooperate on issues of competition law enforcement and other competition issues.

With regard to Monopolies and State Enterprises, there is nothing in the Agreement that prevents the Parties from maintaining or establishing monopolies or state enterprises.

Chapter 16: Temporary Entry For Business Persons

The NAFTA facilitates on a reciprocal basis, temporary entry into their respective territories of business persons who are citizens of the three Parties. The Agreement does not create a common market for the movement of labour. Each Party maintains its rights to protect the permanent employment base of its domestic labour force, to implement its own immigration policies and to protect the security of its borders.

Chapter 17: Intellectual Property

To provide effective protection of IPRs, NAFTA sets out specific commitments including: copyrights, patents, trademarks, industrial designs etc.

An exemption from the Intellectual Property provisions for Cultural Industries was agreed for Canada.

Chapter 18: Publication, Notification and Administration of Laws

Standard procedures for above.

Chapter 19: Review and Dispute Settlement in Anti-Dumping and Countervailing Duty Matters

Each Party reserves the right to apply its anti-dumping law and countervailing law to goods imported from the territory of any other Party.

The Parties to a dispute may choose to appeal to a NAFTA panel rather than use the procedures available under GATT, even for matters clearly related to GATT.

Chapter 20: Institutional Arrangements and Dispute Settlement Procedures

Establishes the institutions responsible for implementing the Agreement including a Trade Commission (comprising of Ministers or Cabinet-level officers designated by each of the Parties) and a Secretariat to serve the Commission.

Chapter 21: Exceptions

The scope of exceptions includes Articles on National Security, Taxation and Balance of Payments. With respect to Cultural Industries, the Agreement shall be governed in accordance with the provisions of the Canada/US Free Trade Agreement.

Chapter 22: Final Provisions

Included in the Final Provisions:

(a) Accession: Any country or group of countries may accede to this Agreement, subject to such terms and conditions as may be agreed between the original NAFTA partners and such country or countries.

(b) Withdrawal: A Party may withdraw from the Agreement six months after it provides written notice of withdrawal to the other Parties. If a Party does withdraw, the Agreement remains in force for the remaining Parties.

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