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UPDATE: NORTH AMERICAN FREE TRADE AGREEMENT

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I. INTRODUCTION

The North American Free Trade Agreement ("NAFTA") currently under negotiation among the United States, Mexico and Canada will create a North American Free Trade Area that encompasses some 360 million people with almost $6 trillion in gross output.

The NAFTA seeks the eventual elimination of all barriers to trade in goods and services through the reduction and eventual elimination of tariffs, the elimination of non-tariff barriers, such as quotas and licensing requirements, the elimination of investment barriers and the development of alternative dispute resolution and consultation mechanisms.

While the purpose of the NAFTA is to increase North American trade, its impact on any particular country or company can vary significantly. Accordingly, it is important for any company which does business in North America to analyze the potential effect that the NAFTA could have on its operations.

We provide the following report to assist business executives in familiarizing themselves with the current parameters of the NAFTA, as well as to indicate what can be expected once the agreement is concluded. Section II of this report summarizes the current status of the negotiations. Section III identifies the major issues in selected negotiating groups, providing examples, where appropriate, of the potential impact of the NAFTA on current business activities.

This report is designed to provide general information only, and is not intended as legal advice. The advice of legal counsel should be obtained on specific questions regarding how the NAFTA could affect individual company operations.

II. CURRENT STATUS OF NEGOTIATIONS

A. Negotiating Groups

The United States, Mexico and Canada have established 19 negotiating groups to cover the major areas of negotiation among the three countries. The 19 groups cover the following general areas:

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a. Trade in Goods

- Tariff and Non-Tariff Barriers
- Rules of Origin
- Procurement
- Agriculture
- Autos
- Textiles
- Energy
- Safeguards, Subsidies and Trade Remedies

b. Standards

- Health and Safety
- Industrial

c. Services

- Principles
- Financial
- Insurance
- Land Transportation
- Telecommunications
- Other Services

d. Investment Access

e. Intellectual Property

f. Dispute Settlement

The U.S. negotiations are headed by the U.S. Trade Representative, Carla Hills. The Mexican negotiating team is headed by Mexican Secretary of Industry and Commerce, Jaime Serra Puche, and the Canadian team by Canadian Minister of International Trade, Michael Wilson.

B. Progress in the Negotiations to Date

The formal NAFTA negotiations were inaugurated with a "Plenary" meeting of Chief Negotiators in Washington, D.C. on July 3-9, 1991. Since that date, each of the negotiating groups have met several times in various cities in the United States, Mexico and Canada. The chief negotiators have also met periodically, to make policy decisions.

After gathering information regarding the laws, policies and practices of each country evaluating their relative trade positions, and with input regarding the concerns of their respective domestic industries, the country representatives exchanged formal negotiating positions and have begun drafting a joint text. There is currently circulating a draft text of over 500 pages in length covering every area of the negotiations.

While the United States initially stated optimistically that the NAFTA target date for completion of negotiations was January 1, 1992, the target date now being suggested for an agreement is no earlier than year-end 1992. The delays are due in part to the fact that the same U.S. officials responsible for negotiation of the NAFTA are also responsible for the Uruguay Round of General Agreement on Tariffs and Trade ("GATT"), but also reflect the number, complexity and political sensitivity of the issues. In addition,

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with presidential elections scheduled in the United States for November 1992, many analysts suggest that the United States will hold off presenting an agreement to the U.S. Congress, even if one is completed prior to year-end, to avoid the election year politics. The effect of election year politics on the negotiations will vary by sector, with probably a greater impact on agriculture, as well as on autos and textiles, which have strong union backing. Prominent Democrats, such as House Majority Leader Richard Gephardt, are pressing for tough rules of origin and anti-dumping provisions, among others. The politics of the agreement is important because ultimately, the U.S. Congress will have to vote up or down on any agreement reached.

C. Congressional Oversight

In addition to the role of the official U.S. negotiators, several U.S. Congressional Committees will be highly influential in overseeing the NAFTA negotiations, and eventually in the approval process.

The Senate Finance Committee and the House Ways and Means Committee will play key roles. Other oversight committees, such as the Senate Agriculture Committee or Banking Committee (depending on the issues), will also monitor the negotiations, hold hearings and eventually vote on any final agreement reached. The activities of the Committees are directly related to the strength of lobbying by U.S. interest groups regarding their particular positions. The opportunity for comment leads to the possibility of political tradeoffs.

D. U.S. Interest Groups

There is a broad range of interest groups who will lobby the U.S. government and the Congress to assure that their particular interests are taken into account in the negotiations. Private interest groups include coalitions formed among major producers in an industry, such as U.S. orange juice producers, as well as ad hoc groups interested in anything from environmental to immigration issues.

In addition to the private coalitions, the government has selected certain representatives of U.S. industry to participate on government sponsored "Technical Advisory Committees." These committees will contribute directly to the process, with access at times to the U.S. government's negotiating positions.

The views of these groups may heavily influence the course of the negotiations, as they are reflected in the official U.S. negotiating position. The Mexican government, as well, seeks input from Mexican business interests in developing its negotiating strategies.

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III. MAJOR ISSUES IN THE NEGOTIATIONS

The sector negotiations believed to be of most general interest are discussed below, with our assessment of the current situation and likely outcome.

Many of these, including investment restrictions, protection of intellectual property, reduction of import barriers, and service industry establishment rights, will be familiar to third country firms and their governments. These "market opening" measures have been the focus of U.S. trade policy since the beginning of the Reagan Administration, and the subject of numerous bilateral negotiations and several "Section 301" cases.

We note also that many of the changes the United States seeks in Mexican law and the treatment of U.S. goods, investment and services have already been independently implemented by the Mexican government or are in the process of implementation. One of the principal U.S. objectives in the NAFTA is to discourage future adverse changes by incorporating Mexican practice into an international treaty, the violation of which would constitute a breach of international law and lead to serious economic, political and legal problems for Mexico.

1. Tariff Reductions

The goal of the NAFTA is to reduce all tariffs in trade among Canada, the United States and Mexico to zero within a defined period of time, probably 10 to 12 years.

NAFTA negotiators indicate that tariff reductions will be phased-in as in the U.S.-Canada FTA ("CFTA"), i.e., some tariffs will be eliminated immediately as the NAFTA goes into force. Tariffs on other products will be eliminated over an intermediate period (5-6 years), and the final group over a longer period (10-12 years or even longer).

As a result of these reductions, Mexican producer exports should be expected to enjoy a competitive advantage over exports to the United States from third countries, within a relatively few years.

The three countries exchanged their first offers of tariff cuts on September 19, 1991. The offers list each Harmonized Tariff Schedule ("HTS") item and indicate the proposed phase-out period. Mexico proposed to reduce 25 percent of its tariffs to zero immediately, 10 percent over the intermediate period, and 65 percent over the long period. The United States proposed immediate cuts of 50 to 60 percent, 6 percent over the intermediate period, and 30 to 40 percent over the long term. Fourteen percent of Mexican

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imports already enter at zero and another 31 percent currently enjoy duty-free treatment under the U.S. Generalized System of Preferences ("GSP"). Canadian proposals are being treated as confidential. As with the United States, Canada will preserve duty-free treatment and any reduced duty GSP ("GPT") benefits already provided to Mexico.

Under U.S. proposals, products which now enter the United States from Mexico duty-free under MFN tariffs or GSP preferences would continue to enjoy duty-free treatment in the future. This is significant, as it would protect Mexico from being "graduated" from GSP, as was the case for Korea, Singapore, Hong Kong and Taiwan several years ago.

Sensitive products such as textiles, footwear, consumer electronics, some chemicals, and many agricultural products, will probably be subject to a longer phase-out period, which has not yet been agreed upon. In some instances, the phase-out may be longer than the 10 years specified under the CFTA.

The agreement will probably contain "snapback" provisions to allow parties to reimpose tariffs where there is short-term injury, for a limited time.

Only products that qualify under the rules of origin as originating in the NAFTA area will qualify for preferential tariff treatment. Third country goods transshipped through one of the countries, or goods produced by one of the parties that do not meet the origin standards, will continue to be subject to the MFN tariffs of each country. (There will be no common external tariff, as in the EEC.)

Should the Uruguay Round of GATT negotiations, the multilateral steel negotiations or other multilateral negotiations result in more rapid tariff reduction agreements among the countries, those reductions would supersede reductions under the NAFTA.

2. Reductions in Non-Tariff Barriers

Much of U.S.-Mexican trade is governed by quotas and import licensing restrictions, particularly in the agriculture sector. It is expected that these restrictions will be eliminated, although Mexican restrictions on U.S. grain, and U.S. restrictions on fruits and vegetables, will most likely be phased out over a long period of time. (If the Uruguay Round is a success, some of the import quota/licensing restrictions may be resolved there rather than in the NAFTA.)

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The United States and Mexico are also negotiating the elimination of quotas on textiles, again over time, and new quotas on such products as steel would be prohibited. These negotiations are complicated by multilateral accords like the multi-fibre arrangement and U.S. efforts to obtain a multilateral steel arrangement, which are also in "transition phases." In our view, it is likely that U.S. quotas on Mexican textiles will be phased out more rapidly than bilateral quotas under the MFA, as Mexico is now urging.

All three countries impose health, sanitary, and safety-based restrictions on imports which in some instances unfairly restrict imports. Some of these will be specifically addressed under the NAFTA. The NAFTA is also likely to contain standardized procedures for challenging such restrictions, and resolving disputes over them. New regulations would have to meet "transparency" and other procedural requirements.

3. Rules of Origin

The NAFTA, like the CFTA, is expected to contain detailed rules of origin. These will determine what goods will enjoy preferential tariff treatment because they are considered to be made in the region. Like the CFTA rules, GSP rules, and the Caribbean Basin Initiative ("CBI") rules of origin, the NAFTA rules will be preferential rules, which only apply to the goods of the three parties to the agreement. There will be considerable variation in the rule of origin by product, with different industries treated in different ways.

The NAFTA rules will not apply in determining origin for purposes of goods from third countries, or from NAFTA countries when those goods do not seek preferential tariffs. (However, the U.S. Customs Service has recently proposed to apply similar rules to all U.S. imports, beginning with steel and steel products.)

The basic rule governing NAFTA origin is likely to be a shift in the Harmonized Tariff Schedule ("HTS") category, either the four-digit or the six-digit categories. In some cases, such as autos, auto parts and chemicals, there is also likely to be a minimum local content requirement. However, most of the local content requirements found in the CFTA rules of origin are not likely to be incorporated in the NAFTA.

The rules of origin will nevertheless be designed to assure that there is substantial processing or transformation performed in the region, or substantial use of local raw materials and components, avoiding "screwdriver" industries. This will be technically accomplished through manipulation of HTS categories. If the U.S. negotiators are successful, it will be more difficult in many instances for a product to qualify for the NAFTA tariff preferences than for CFTA preference.

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For example, a shift from a components category to a finished product category will probably not be sufficient to convey local origin on electronic products assembled in the region, unless some of the components are made in the region as well. The United States is proposing, for example, that a color television receiver made in Mexico not be subject to preferential tariff treatment under the NAFTA unless the picture tube is also made in North America. For computers, the "mother board" would have to be made in North America. Democrats in Congress are pressing for elimination of the "double substantial transformation" standard, in which a major component manufactured in the region is treated as 100 percent local content even if some of the materials or sub-components are exported.

With autos and auto parts, some interests in the United States are advocating that total materials plus direct costs of processing equal 60 to 70 percent of the total value, while Canada favors the 50 percent local content rule now applicable between the United States and Canada. The U.S. "Big Three" -- General Motors, Chrysler and Ford -- are pushing to deny preferential trade benefits to new producers in Mexico. (Nissan and Volkswagen are existing manufacturers in Mexico, along with the U.S. "Big Three.")

With steel, some types of processing, such as galvanizing, that in the past were sufficient to convey origin may no longer do so.

With regard to textiles, the U.S. government does not yet have a position. U.S. industry groups are arguing for stiff rules, which would require the fiber, parts and assembly all to be of North American origin, but U.S. importers are resisting.

Mexican negotiators can be expected to seek to some degree to protect the industries established under the "maquiladora" program in the border regions. However, many of the benefits of the maquiladoras, such as duty drawback and foreign trade zones privileges, are expected to be gradually eliminated under the NAFTA, as under the CFTA.

4. Foreign Investment

Since foreign investment is generally unrestricted in the United States except for a few sectors (defense, airlines, mobile telephone systems, etc.), and generally open in Canada, the focus in those sector negotiations is on Mexico.

The United States is seeking national treatment of foreign investment, and elimination of most restrictions on foreign ownership and control. Restrictions on land ownership by foreigners are of particular interest. The United States is also seeking protection against expropriation, elimination of performance requirements, such as local

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content requirements and export targets, "transparency" of rules and regulations, and binding dispute resolution outside of Mexican courts. NAFTA provisions on foreign investment in Mexican firms may be phased in over a number of years, possibly on an industry-by-industry basis.

Mexico has adamantly refused to open oil exploration and production to foreigners, citing long-standing constitutional provisions. However, some foreign investment privileges are likely to be permitted in the petrochemical industry.

There are those in both the U.S. and Mexican governments that believe at least some of the investment provisions of the NAFTA should be applicable on a most-favored-nation basis, i.e., to third countries such as Korea who invest in Mexico. This would be in Mexico's interest, since Mexico hopes that NAFTA will attract third country as well as U.S. and Canadian investment.

The United States will probably insist that all U.S. companies enjoy the investment and other benefits of the NAFTA, even if the U.S. companies are owned by foreign firms.

The NAFTA itself is not likely to deal with environmental concerns. However, as part of the process, Mexico is expected to improve enforcement of environmental laws and regulations, particularly with regard to air and water pollution and toxic waste. Under separate but parallel negotiation, for instance, the United States and Mexico recently announced a new Integrated Environmental Plan for the Mexico-U.S. Border Area under which the two governments pledged to spend more than $700 million on border environmental issues through 1994.

5. Services

Obtaining access to Mexico for services, particularly banking, insurance, land transport, telecommunications and VANS (value added networks), and professional services is a high priority for the United States, as it has been in U.S. relations with Korea, Japan and other countries.

a. Banking: In the financial sector, the United States seeks elimination of the restriction that foreigners may only own 30 percent of Mexican banks, and significant restrictions on foreign brokerage and insurance operations. Mexico is concerned with U.S. restrictions on banking which under current law make it difficult for a single bank to operate across state lines in the United States, and to engage in related activities such as underwriting securities. The final form of U.S. banking reform legislation now before Congress will necessarily affect negotiations in this area.

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b. Insurance: The United States has few restrictions on foreign insurance companies, but the insurance market is largely regulated by the states. Canada's restrictions are also minor. As of 1990, Mexico permits up to 49 percent foreign ownership of insurance companies, and allows freedom to place reinsurance abroad. U.S. and Canadian negotiators will seek the right for American companies to freely market primary insurance in Mexico, which is now prohibited.

c. Transportation: Land, particularly truck transport, is important because much U.S.-Mexican trade depends on trucks. Free access for U.S. truckers to Mexico is a key issue for U.S. negotiators. It is likely that over time the parties will reciprocally eliminate restrictions on foreign ownership of trucking companies, and take steps to facilitate through movement of trucks and containers. Recent Mexican initiatives to open the frontier region to American trucks will be expanded in the early years of the agreement. The United States will also seek access for U.S.-owned brokers and freight forwarders.

The parties are likely to agree to increased access for the others' buses. Currently, only U.S. charter bus operations may operate freely in Mexico.

Although Canada and Mexico hope otherwise, it is not likely that current restrictions on U.S. coastal shipping will be relaxed as part of the NAFTA negotiations. The United States has refused, to date, to include shipping on the agenda, despite repeated requests from Canada and Mexico. It is, however, possible that some port and terminal issues could be discussed.

It is also unlikely that the parties' restrictions on air services and ownership of airlines will be modified as part of the NAFTA. The United States and Mexico are parties to a Bilateral Aviation Agreement. In negotiations which are parallel to, but not part of the NAFTA negotiations, the United States and Mexico are seeking further liberalization under the Bilateral Agreement in anticipation of increased activity once the NAFTA is completed.

d. Telecommunications: Freer access to the Mexican telecommunications sector is a high U.S. priority, as it has been with Korea, Japan and the nations of the EEC. The United States seeks open access to the Mexican market for long-distance telephone and data services, and removal of regulatory barriers. The privatization of Telmex, already under way, will provide an opportunity for equipment sales. The NAFTA is expected to formalize U. S. and Canadian access to these sectors.

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6. Intellectual Property

Legislation to improve protection for intellectual property in Mexico has now been enacted, which meets some but not all U.S. objectives. The United States wants stronger protection for intellectual property and stiff penalties for violators. U.S. negotiations want provisions for indefinite patent renewal while Mexico wants patents to expire with no opportunity for renewal. The United States would also like stronger protection for computer and industrial design and trade secrets.

Mexico has recently passed legislation to protect copyrights, including computer software and sound recordings. Stiff criminal penalties are provided in appropriate cases.

It is expected that these improvements in Mexico's intellectual property laws should benefit third country patent holders, not just U.S. and Canadians. Incorporation of these provisions in the NAFTA would create a binding commitment on all parties and prevent unfavorable changes in the law at a later time.

7. Antidumping and Countervailing Duty Laws

Mexico, like Canada in the CFTA negotiations, is seeking special provisions in the application of U.S. antidumping and countervailing duty ("CVD") laws to Mexico. In particular, Mexico would like to see a broader de minimis exception (three to five percent) to the practice of cumulation, so that Mexico could not be drawn into multi-country antidumping cases when Mexico is a minor producer. Mexico also seeks a "sunset" provision automatically terminating such trade cases after a certain period (three to five years), tighter U.S. rules on who can bring an antidumping or CVD case, and other technical benefits. Mexico would also like to see a clear, broad definition of certain types of government subsidies that would not be subject to CVD cases.

For domestic political reasons, it is highly unlikely that the United States will make major concessions in its antidumping and countervailing duty laws in this trilateral negotiation, unless it becomes obvious that the Uruguay Round discussions will fail. The United States made no substantive concessions on these issues in the CFTA. It only agreed to set up working groups, which have accomplished little.

The United States and Canada did agree in the CFTA to a special appeals procedure for antidumping and CVD cases, removing them from the jurisdiction of the federal courts in Canada and the United States. This was a key element of the CFTA for Canada. It is unclear whether the United States will seek a similar mechanism in the NAFTA; the process is complicated by the differences in legal systems and Mexico's lack of transparent antidumping procedures. (Mexico has had an antidumping law since

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1967 and has brought more than 60 cases, mostly against U.S. and EEC producers.) Mexico, however, has indicated that it would like to see an antidumping and countervailing duty review mechanism similar to the one adopted in the CFTA.

8. Government Procurement

Canadian and U.S. access to Mexican government purchasing could be an important source of exports for both countries. Canada and the United States, but not Mexico, are parties to the GATT Government Procurement Code, which was used as a basis for the government procurement sector agreement of the CFTA.

The government procurement sections of the NAFTA are likely to be "stand alone" provisions, which will operate among the three countries in the region regardless of whether Mexico eventually accedes to the GATT Code. However, the NAFTA provisions should of necessity be compatible with the Code.

A key issue will be the list of government-owned or controlled entities in each country that will be subject to open bidding and procurement procedures for firms from any of the NAFTA countries. The United States hopes for a comprehensive agreement covering all non-military procurement of goods and services by Mexican agencies, as well as access to public works construction projects, for all contracts over a certain minimum amount (perhaps $25,000, as in the CFTA). Because of the size of U.S. federal government procurement, Mexico has a substantial reciprocal interest. The United States and Canada will also press for transparency in all phases of the procurement process, and for effective challenge procedures.

9. Dispute Settlement

Mexico, the United States and Canada are certain to include a conciliation and binding arbitral mechanism for resolving disputes arising under the NAFTA, as in the CFTA. The scope of the dispute settlement provisions in the NAFTA may well be broader than the mechanism in the CFTA, particularly if the Uruguay Round talks fail to produce a satisfactory multilateral dispute resolution mechanism for trade disputes.

Such a mechanism could be a substitute for some Section 301 actions by the United States. The CFTA mechanism has not prevented Canada from taking several disputes to GATT panels, but in some instances, has encouraged negotiated solutions. The United States has taken a dispute over market access for U.S. produced beer to the GATT, and received a favorable decision. The mechanism for resolving antidumping and countervailing duty case disputes provided in Chapter 19 of the CFTA has been used in more than 20 cases, and has worked well.

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IV. CONCLUSION

The NAFTA should provide tremendous advantages to companies operating in the North American Region, as a result of the greatly expanded market access and investment opportunities which the agreement will provide. While trade in goods and services between the three countries in the region is already significant, the NAFTA should expand inter-country business activity and stimulate the economies of the countries to the advantage of the region and its peoples as a whole.

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