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Committee on Regional Trade Agreements Third Session

EXAMINATION OF THE NORTH AMERICAN FREE TRADE AGREEMENT

NOTE ON THE MEETING OF 30 JULY 1996

Chairman: H.E. Mr. Lode Willems (Belgium)

1. The Committee on Regional Trade Agreements continued its examination of the North American Free Trade Agreement¹ under Agenda item B2 of its Third Session.² The following items were treated:

Examination of the Goods Aspects of the North American Free Trade Agreement

- Chapter One: Objectives
- Chapter Three: National Treatment and Market Access
- Chapter Four: Rules of Origin
- Chapter Five: Customs Procedure
- Chapter Six: Energy and Basic Petrochemicals
- Chapter Seven: Agriculture
- Chapter Eight: Emergency Action
- Chapter Nine: Technical Barriers to Trade

Examination of the Goods Aspects of the North American Free Trade Agreement

Chapter One: Objectives, (Additional Questions from document WT/REG/4/1/Add.1)

2. The representative of the NAFTA said that all three NAFTA Parties were of the view that the Agreement had functioned well during its first two-and-a-half years of existence and that it fully met the Parties' multilateral trade commitments.

3. The representative of the European Communities said his delegation strongly supported the process of North American and Latin American economic integration. It was unfortunate that the resumption of the NAFTA examination was so late, but as the NAFTA had been in force for a number of years, the Committee was able to look at its effects. Regional integration through either customs unions or free trade agreements was permitted, provided that it did not harm the interests of others and that it did not undermine the fundamental non-discriminatory architecture of the world trading system. Article XXIV of GATT 1994 provided the authority for regional integration agreements and the rules to ensure that any harmful effects would be mitigated. The difference between free-trade areas and customs unions warranted further consideration, both in terms of their broad economic impact as well as the implications for WTO disciplines. A free trade agreement could be just as significant

¹The meeting was convened in WTO/AIR/387.

²The note on the first meeting on the examination of the NAFTA is contained in document WT/REG4/M/1.

in its trade impact as a customs union, but face significantly less stringent rules. The difference in the treatment of the two in the regulatory framework had increased as a result of the Understanding on the Interpretation of Article XXIV of the GATT 1994, which further strengthened rules on customs unions only. His delegation had observed trade diversion over the last two years with respect to Mexico, following tariff increases by Mexico. The fact that these increases had been within bound rates and, strictly speaking, outside the scope of the NAFTA itself did not alter the concern. This was a significant systemic issue. There was a specific difficulty created when a member of a free-trade area maintained - and especially when it increased - high levels of most-favoured-nation (MFN) protection, even within the bound tariff rates. His delegation also remained concerned over NAFTA rules of origin, which were relevant to the "other regulations of commerce"-test, found in Article XXIV:5. The core of the concern was that in some sectors, such as textiles and automobiles, the effect seemed to be to manage trade and to prevent the full trade-creating benefits of the liberalization process from developing. The fifteen year transitional periods for some products did affect a very small volume of total trade, but that relative volume could not in itself be a justification for a long transitional period. A more objective justification was required. Aspects of the duty draw-back and relief arrangements were also of concern, and institutional issues, such as the separate dispute settlement system, had already been identified as issues which needed to be addressed in the context of a systemic debate. The risk of overlapping systems and the possibility of conflicting jurisprudence also needed to be addressed.

4. The representative of Japan said that some provisions of the NAFTA were problematic: some were difficult to understand, some were so complex they increased the administrative burden of foreign enterprises, and some raised the question of inconsistency with Article XXIV. He questioned why the answers were circulated only two weeks before the examination. Since that sort of document was essential to the task of the Committee, it would be appropriate to set a submission deadline, in order to ensure that each delegation had time to analyse it. He questioned the basic rationale behind Article XXIV's sanctioning of free trade agreements, which, in effect, was a major derogation from the MFN principle. It was based on the assumption that free-trade areas would have a trade-creating effect, due to the removal of tariffs within the free-trade area, and that these effects would exceed the trade-diverting effects. As it had been two-and-a-half years since the NAFTA had come into force, his delegation expected an explanation from the NAFTA Parties of both the trade-creation and trade-diversion effects, based on the latest data, including those of 1995.

5. The Chairman said that additional questions had been sent to the NAFTA Parties on 22 November 1995. Replies had been received in mid-July 1996 and had been circulated to delegations a few days later, on 22 July 1996.

6. The representative of Korea shared the concern expressed by the Japanese delegation over the belated circulation of the additional question and answer documents. He noted, however, that the responses were detailed and comprehensive.

7. The representative of Australia also hoped that in the future delegations would be able to receive responses earlier. Like the Japanese, the Australian delegation would appreciate more information on 1995 data, if available, for comparison purposes. He did note that in the additional answer to question 5, a table had been provided. It would be helpful if the Parties could compare the growth in their imports from non-NAFTA sources, with the growth in their imports from other NAFTA Parties. Third countries had an interest in ensuring that any trade diversion was offset by growth in imports from non-parties and that the agreements were as liberalizing as possible - at the very least, consistent with the minimum standard established by Article XXIV.

8. The representative of the European Communities referred to the reply to question 2, page 3, of document WT/REG/4/1/Add.1. His delegation was of the view that a significant point had been made in the response about the question of stability, transparency and predictability in terms of product

coverage. However, his delegations' concern went beyond the point of product coverage. It went to the heart of section 4 of Article XXIV, which stated that a free-trade area should facilitate trade between the constituent territories and not raise barriers to trade with other contracting parties. An unstable, non-transparent or unpredictable framework would undermine the general presumption as to how a free-trade area ought to operate. On the question of what constituted a good of a Party, the NAFTA partners had answered that according to international law, they could jointly agree to change any provision of their agreement. Did the Parties have any comment to make on the general proposition that a stable, transparent and predictable framework of trading rules was a relevant consideration for the general Article XXIV:4 test, or could be a guide to the establishment of free trade agreements? Further, in reply to supplementary questions 7, 8 and 13, the NAFTA Parties had answered that the NAFTA rules of origin had been constructed so as to avoid trade diversion and to define the goods that were eligible for preferential treatment. The responses did not go to the heart of the question that had been raised. The concern was that some of the particular sectoral rules could have the effect of restricting the ability of third parties to benefit from the general liberalizing objective of the NAFTA. The result could be that the trade creation possibility for third parties became subject to a special restriction which had the effect of raising a barrier to the trade of other contracting parties. Did the NAFTA Parties have any comment to offer in response to these concerns?

9. The representative of the NAFTA said that the process by which questions were submitted and replies provided needed to be discussed in a broader context of the Committee. The NAFTA Parties had received the first batch of questions in November 1995, but had continued to receive questions in a piecemeal fashion all the way through February. The NAFTA Parties had tried to compile the questions into sections, and to answer them as fully as possible in putting a comprehensive package together. They would endeavour to provide the 1995 trade data as soon as possible. However, in the answer to question 5, it was noted that intra-NAFTA trade had gone up by 17.3 per cent. That would give a benchmark for comparing the increase in trade among NAFTA Parties to that from outside the NAFTA. Preliminary information, at least in the case of Canada, further suggested that imports from the rest of the world continued to rise at a significant rate. He then turned to the question of the European Communities on question 2, concerning stability, predictability and transparency, and said that in entering into the NAFTA, one of the primary objectives of all three NAFTA Parties had precisely been to promote transparency, predictability and stability. This was best demonstrated by the efforts undertaken in the area of rules of origin. Much detail had been provided in the provisions on rules of origin, not only in the NAFTA, but also in the domestic regulations, which were identical in all three countries. The desire had been to provide as much information as possible to producers within the region. There had also been an effort to consult before changes had been made. The proposals had been published for public comment, the comments had then been taken into account and the final results had been published in advance. They had also been duly notified to the WTO. Transparency, predictability and stability were principles all three NAFTA parties were striving toward, both within the NAFTA and within the WTO. The NAFTA rules of origin determined which products were eligible to receive the NAFTA tariff preferences, and had no other objective. There was a growing body of literature that suggested rules of origin served all sorts of other motives.

10. The representative of the NAFTA continued by responding to the statement made by the representative of the European Communities that, because of tariff increases, there had been trade diversion with respect to Mexico. The year 1995 had been an atypical year with respect to Mexico. In December 1994 there had been a serious financial crisis, which had led to a general contraction of imports. "General" was an important word, because it referred to imports from the entire world and not only from the NAFTA Parties. Data broken down according to the source of supplies of imports, as requested by the Australian delegation, would be provided when available. However, such a breakdown of the trade data would reflect not only the effects of the NAFTA; there were other factors to be taken into account, such as the relations which existed traditionally between production sectors in Mexico and producers in the United States and Canada. The United States had been Mexico's

traditional trading partner, with respect to three-quarters of its trade, greatly predating NAFTA. Factors such as geographical proximity and exchange rates should also be taken into account. Import statistics alone did not provide the entire picture of the situation. Mexico had also had a trade deficit with the European Communities, as well as with Asia, while it had had a surplus with the NAFTA partners. In replying to the question on tariff increases, he said that he was pleased to note that the representative of the European Communities had not called into question the legitimacy of such increases, which only related to a limited number of products and which were lower than the bound tariff.

11. The representative of Argentina expressed concern over the predictability of regional trade agreements. All members of regional trade agreements should respect the Understanding on Article XXIV. In particular, developments in the agreements should be reported as they occurred.

12. The representative of the European Communities said he found the response to be couched in terms of stability and predictability. The NAFTA Parties had referred to "producers within the region," whereas his delegation was also interested in stability and predictability for third parties. His delegation's concern, that the rules of origin in particular sectors restricted opportunities for third parties, remained. The tariff issue was still a factor to be taken into account in the debate on the interpretation of Article XXIV:4. Changes in customs valuation procedures also needed to be considered.

13. The representative of the NAFTA stressed that concerning stability, predictability and transparency, the NAFTA Parties had endeavoured to notify the WTO of changes made to their Agreement. The NAFTA Parties recognized that transparency, predictability and stability were important not only for producers and investors within the NAFTA region, but also for the global trading system. It was important for everyone to understand the NAFTA process, and the NAFTA Parties would continue to work for that. He said that the requested trade figures would be provided, but stressed that they should be put in the proper context. The NAFTA Parties were of the view the NAFTA had not resulted in a reduction of imports from other regions. This view was supported by the trade figures provided.

Chapter Three: National Treatment and Market Access

14. The representative of Argentina requested some further clarification on the second paragraph of the Canadian reply to question 19 in document WT/REG/4/1/Add.1/Corr.1 regarding unprocessed fish. It stated that the regulation of off-shore processing of fish was a provincial responsibility and that East Coast provinces retained the right to maintain existing provincial control on the export of unprocessed fish. Did not the provincial control constitute a step away from consistency with regard to the application of the rules to that product, or was it simply a matter of attributing or granting responsibility?

15. The representative of the Canada replied that, according to Canada's constitution, this was the responsibility of the provinces. That was also why it was a provincial regulation in terms of the obligations under the NAFTA. In clarifying the response to question 29, he said that Article 703.3 of the NAFTA permitted special safeguard actions on certain agricultural products to be taken in the form of transitional tariff-rate quotas (TRQs). These TRQs were specified in the tariff schedule of each country.

16. The representative of Korea sought clarification from the Mexican side to answers supplied to questions 53 and 54 in document WT/REG4/1/Add.1. According to the current NAFTA regulations, certain Mexican trade-related investment measures, (TRIMs), would remain effective until the year 2004, while the TRIMs Agreement only allowed for a five-year transitional period for developing countries, unless extended. The concern was that the provision was not consistent with the TRIMs Agreement and that the Mexican Government had not clearly expressed whether it intended to request an extension. According to his delegation, the existing NAFTA regulation did not conform to the relevant provisions

of the WTO Agreement. The NAFTA regulations should stipulate the same transitional period as the TRIMs Agreement. Whether Mexico requested an extension of its TRIM at the time of its expiry was a different matter.

17. The representative of the European Communities questioned the way in which the 15-year transitional periods were justified. In the reply to question 24, the NAFTA Parties had explained that "within 10 years, more than 99 per cent of United States imports, and virtually all Canadian imports into Mexico, will be duty-free". The NAFTA Parties had then stated that the NAFTA would cover substantially all the trade within a reasonable length of time. His delegation's concern was that the response did not necessarily justify the longer phase-out period. He would therefore like the NAFTA Parties to comment on that particular point. In his delegation's view, Article XXIV was not meant to be read in such a way as to allow the parties to a regional trade agreement to merge the provisions of Article XXIV on coverage of substantially all trade with the separate question about the transitional period. A second remark related to question 32 of the original document, WT/REG4/1. His delegation would appreciate a reply from NAFTA on the point that had already been made, that for the wider question of regional integration, the Parties' MFN-tariffs or MFN-regulations of commerce were relevant to the Committee's discussion of Article XXIV:4. Furthermore, the supplementary replies to questions 38, 39 and 41, asserted that the NAFTA Article 303 applied only to trade among NAFTA Parties. In other words, the drawback and duty-deferral programmes relating to non-NAFTA trade were, by definition, not affected, and therefore could not be considered to be higher or more restrictive than those existing prior to the formation of the NAFTA. It seemed valid to look at the way the programmes were administered in practice. The issue related back to the point on stability and predictability, as well as to the general point that had been made in relation to Article XXIV:4 on MFN actions by the NAFTA Parties. A final comment related to the response given to question 43, where the NAFTA parties correctly noted that the reference in Article XXIV:5 was not to "applied" duties and other regulations of commerce, but to the "applicable" duties and other regulations of commerce. That was also an area where, as a result of the Uruguay Round Understanding on the Interpretation of Article XXIV, the framework of rules for customs unions and free trade agreements had begun to diverge significantly.

18. The representative of the NAFTA first referred to the question put by Korea. The time-periods in the NAFTA were different from those which the Korean delegation had quoted. They could be found in Article V:3 of the TRIMs Agreement, which contained an explicit provision relating to the possibility for the Council on Trade in Goods to extend the phase-out period of TRIMs notified under the provisions of Article V:1. The Mexican automobile provision in question had been so notified. He did not share the view that there was an incompatibility between the automobile provisions of the NAFTA and Mexico's obligations under the TRIMs Agreement. While Mexico could apply for an extension under the TRIMs Agreement, thus far its trade and development situation had not required it to do so. The written reply to questions 53 and 54 had specified that all information relating to the Automobile Agreement had previously been supplied in accordance with the TRIMs obligations. Relating to the 15-year period, two possible interpretations of the phrase "exceptional cases" had been set out. That had been done because a number of agreements, including that of the European Communities, also used the extended time period for other provisions. The NAFTA used it only on a product-by-product basis for a small number of products that did not account for a substantial amount of trade: only one per cent of the total trade between Mexico and the United States, 0.0003 per cent of the total trade between Mexico and Canada, and zero per cent of the total trade between Canada and the United States. The NAFTA Parties had used the protective measure of maintaining a 15-year extension period because they were of the view that, from a realistic standpoint, they were importing more than they could usefully absorb.

19. The representative of Mexico said that his delegation was of the view that Article XXIV addressed two major elements. The first one was to favour trade, as between the member territories of an

Agreement. The second one was not to raise barriers to trade with other Contracting Parties. The NAFTA had raised no additional barriers for non-members - either in terms of tariffs, or in terms of other trading rules.

20. Another representative of the NAFTA, in clarifying the answers given to the questions on drawback and duty deferral, said that, first, no country was obliged to grant drawback or duty deferral provisions. In other words, the removal of a programme of duty deferral and drawback could not infringe upon any WTO provision. Second, the NAFTA system did not alter the MFN arrangements that applied to imports from third countries, which were intended for domestic consumption. Third, the existing drawback programme was not affected in terms of trade exported to third countries. Fourth, when exports were sent to the territory of another NAFTA Party, the NAFTA rules provided that the exporter had the option of not seeking preferential treatment and maintaining the status quo - in other words, the drawback or duty deferral system. Fifth, the intention behind the new programme was for non-originating inputs to be subject to tariffs only once, not twice, cases when they enter a NAFTA territory. The intention was to maintain the same exporting conditions as if the product had been intended for a non-domestic market. For these five reasons it was erroneous to assert that the programme resulted in increased trade barriers. In referring to the comment from the representative of the European Communities concerning question 43, he said that his delegation agreed that the issue of the differing bound rate and applied rates was a systemic problem. However, he did not share the Communities' view that it was a systemic issue specific to regional trade agreements; rather, it cut across the entire WTO system of rules.

21. The representative of Japan said that, despite the explanation given by the NAFTA Parties, foreign companies doing business in the NAFTA area were greatly affected by the abolition of drawback and duty referral. For instance, a foreign manufacturer which was engaged in Mexico's Maquidora, and which was exporting his products to other NAFTA Parties, would have to pay import tariffs on imported parts and materials from the NAFTA countries, even though these inputs had been exempted for a long time. Article XXIV:5(b) provided that duties and other regulations of commerce should not be higher or more restrictive than those existing prior to the formation of the free trade agreement: yet the dismantling of the long-established drawback and duty referral programme translated into higher tariffs and import restrictions. Another point, if the Maquidora and Pitex systems were to be established by the year 2001, as they were scheduled, his delegation requested that the new tariff system replacing these programmes be made public, in the early stages.

22. The representative of the European Communities said that, according to Article XXIV:4, it was permissible to form free trade agreements or customs unions, provided Members did so in a way that did not harm others or undermined the broad, non-discriminatory architecture of the multilateral trading system. His delegation would like to pick up the invitation offered, particularly by the United States, to use Article XXIV:4 in a wider sense, that was, to look at the context of a particular agreement and see what conclusions or systemic issues might emerge. The question of applied versus applicable duties had to be a systemic issue spanning wider than the area of regional agreements, and it was one of the systemic issues which might need further consideration by the Committee.

23. The representative of Argentina wondered whether Japan, in one of its questions, was objecting to the idea that a free-trade area which had zero duties among its parties could eliminate duty drawback? Should that be regarded as an impediment to the conditions that had prevailed previously?

24. The representative of Japan explained that his delegation did not oppose the idea of a free-trade area itself, but rather was concerned with the treatment of non-NAFTA countries.

25. The representative of the NAFTA clarified that in the NAFTA an option existed for a producer in a NAFTA territory to maintain the status quo, that is, to maintain the existing drawback provisions

and operations, if he wished to do so when exporting to the territory of another NAFTA Party. Producers choosing not to claim tariff preferences would always be entitled to rely completely on the total drawback of the previous scheme. They could either make a complete deduction or claim tariff preferences under the NAFTA when they exported to the territory of another Party. The purpose was two-fold: first to avoid double taxation, and second, to ensure that the producers would pay the same duties regardless of whether they claimed the tariff preference in exporting to another NAFTA country, or sold for domestic consumption. He also reiterated that the NAFTA provisions would not at all change the MFN duties applicable to inputs imported from non-parties.

26. The representative of Japan referred to question 30 and said that, according to the NAFTA Parties' answer to that question, principal and substantial supplier status would be determined in accordance with GATT Article XXVIII and the Understanding on the Interpretation of Article XXVIII. These documents would be taken into consideration in determining which Members had principal or substantial supplying interests with regard to MFN-based trade in a particular product. Should the volume of preferential trade among the NAFTA countries not therefore be considered as one of the factors which determined such status? A second comment related to question 52 on the Agreement Concerning Automotive Products between the Government of Canada and the Government of the United States of America. Annex 300A, paragraph 1 of the NAFTA allowed the Canada - United States Automotive Agreement to remain in force. With regard to the import tariff on completed automobiles, this Auto Pact discriminated between automobile companies designated for special treatment under the Canada-United States Automotive Agreement and those not so designated: the beneficiaries of the Canada-United States Automotive Agreement were exempted from the import tariff when importing completed automobiles, while others were not. The difference was further enlarged by abolishing a duty drawback and remission system. Was this consistent with WTO rules?

27. In reply to the question on principal and substantial supplier status, the representative of the NAFTA said that the NAFTA Parties would act in strict conformity with the letter of Article XXVIII and its Understanding.

28. The representative of Canada confirmed that the Canada-United States Automotive Agreement was maintained in the NAFTA with regard to companies benefiting under that Agreement. Any Canadian company meeting the criteria of the NAFTA rules of origin could import duty-free from the United States or Mexico. The drawback provision was an entirely separate issue that had been eliminated from the new provisions.

Chapter Four: Rules of Origin

29. The representative of the NAFTA said that the revision of the Uniform Regulations for Chapter Four, Rules of Origin of the NAFTA, had been notified to the WTO, pursuant to the notification requirements under the WTO Agreement on Rules of Origin. Changes that had been made to Annex 4.1 - which, in the view of the NAFTA Parties were of a non-substantive nature, in terms of technical rectifications to the rules, and which were of a substantive nature, in the case of the chemical rules - had also been notified previously, pursuant to the WTO Agreement on Rules of Origin.

30. The representative of the European Communities referred to the reply to the first general question on page 14 of document WT/REG/4/1/Add.1, which indicated that, in the view of the NAFTA Parties, the preferential rules of origin did not function in a restrictive manner with regard to MFN tariffs or other policy instruments. A similar response had been given to question 58. Two examples of areas in which MFN tariffs had historically been particularly restrictive, or simply convoluted and difficult to operate, were those of textiles and automobiles. In these areas, the preferential rules of origin had the effect of making it more difficult for third-country suppliers to benefit from the slightly larger market, or the trade liberalizing opportunities. The result was more restrictive than if the general NAFTA

approach to rules of origin and the general transparency and predictability requirements of the other regulations of commerce had been followed. Regarding supplementary question 58, his delegation wondered whether the Parties intended to extend the derogation procedure for the textiles sector, and if so, for which products. He agreed with the reply to question 65, which indicated that the general use of tariff classification in the rules of origin provided predictability. This general approach stood in contrast to particular arrangements which had been made, for example those dealing with textiles and the automobile sectors. He then turned to the response to question 88. In the broad category of the textiles sector, the particularly restrictive preferential rules of origin effectively diverted trade: trade functioned well within the NAFTA, but existing market opportunities from textile suppliers outside the NAFTA were removed.

31. The representative of Switzerland said that his government was concerned with some aspects of the rules of origin regime set up within the NAFTA. The regime was not a purely technical instrument. Rather, the criteria for obtaining NAFTA origin turned the NAFTA rules of origin into a set of measures which lead to trade diversion in some sectors. He agreed that the NAFTA rules of origin increased transparency, but his delegation questioned their consistency with respect to the relevant WTO provisions, particularly Article XXIV, for the same reasons as those put forth by the European Communities.

32. The representative of Japan said that the NAFTA Parties claimed that preferential rules of origin did not function in a restrictive manner with regard to MFN treatment, tariffs, and other policy instruments applying to imported goods from non-NAFTA countries. It was the view of his delegation that by tightening a value-content requirement, rules of origin could have a restrictive impact on imports. In some sectors, such as the textiles and automobile sectors, the NAFTA rules of origin did seem more restrictive than those of the United States-Canada Free Trade Agreement. He would welcome clarification on this point. His second comment related to the reply given to part (b) of the general question on rules of origin, which stated that the NAFTA's consistency with Article XXIV should be examined, rather than its consistency with or comparison to other free trade agreements. However, Article XXIV:5(b) stipulated that duties and other regulations of commerce should not be higher or more restrictive under the NAFTA, than those that existed before the formation of the NAFTA. His delegation therefore considered it necessary to scrutinize provisions in comparison with those of the United States-Canada Free Trade Agreement, and would appreciate hearing the NAFTA Parties' views on this. Last, his delegation had asked the NAFTA Parties why the automotive sector had special and complicated rules of origin. The original answer to this question had been that motor vehicles, which comprised a large number of components, required a precise calculation of local content. A follow-up question asked why the same special rule was not used for aircraft, which also comprised a large number of parts. To this, the NAFTA Parties had responded that, when drafting the NAFTA, they had tried to develop rules of origin devoid of a value content percentage methodology, and that this had proved feasible in many product sectors, including aircraft, but not in the automotive sector. Could the NAFTA Parties please state the reason for this failure?

33. The representative of Korea said that rules of origin might act as a trade-diverting instrument to be used against products originating in third countries. This was particularly the case when rules of origin were based on local content. In the case of textiles in the NAFTA, the supplier who used fibre or yarn that originated in third countries was no longer entitled to enjoy the preferential tariff. Before the formation of the NAFTA, the Parties applied rules based on criteria such as cutting assembly. Meeting the new rules of origin applicable to the textiles sector might encourage the use of more local materials than before, thus creating a bias towards domestic industry. His delegation found this to have been the case with the NAFTA, whose formation seemed to have led to trade-restrictive effects, in terms of the rules of origin. A second point concerned the rules of origin for trade in automobiles. His delegation agreed with the position that this Committee should examine the consistency of the NAFTA, including its rules of origin, with Article XXIV and not examine it for consistency with or

in comparison to other free trade agreements. However, the rules of origin of the United States-Canada Free Trade Agreement could be used as reference to determine the conformity of the NAFTA with the relevant Article of the GATT. He then raised a point with regard to the hypothetical automotive example in part (b) of the first general question on rules of origin. The foreign automobile manufacturers cited in the question would trade at MFN rates. Trading at those rates would be more disadvantageous for those manufacturers under the NAFTA rules than under the United States-Canada Free Trade Agreement if they did not change their production processes to meet the more restrictive rules of origin, even for the intra-regional trade. The hypothetical case demonstrated that even trade within the NAFTA could be adversely affected by the rules. Finally, his delegation wished to get clarification from the NAFTA Parties as to whether passenger-carrying capacity would be the basis of a difference in the required rate of local content, for the purposes of rules of origin.

34. The representative of the NAFTA said that a preferential rule of origin determined which products were eligible for preferential treatment. He agreed that these measures were somewhat discriminatory. A free trade agreement provided for preferential rates, and a rules of origin regime represented one of the operational features of a free trade agreement. Article XXIV:5(b) stated that tariffs and other regulations of commerce of a free-trade area could not be raised or made more restrictive vis-à-vis imports from outside the area. Nothing in the NAFTA raised a tariff or imposed a new quota or anything else on imports, be they from outside the NAFTA region or from within. Furthermore, any product trans-shipped from outside the NAFTA through a NAFTA Party would continue to face the same tariff rates and regulations as before the NAFTA had come into effect. The only difference was that, in order to qualify for a tariff preference, goods traded among the Parties were required to meet the rules of origin. The Parties wished to ensure that producers whose goods qualified for the tariff preference, did carry out some production within the region. However, his delegation was not of the view that there should be a comparison of the rules of origin under the NAFTA to those under the Canada-United States Free Trade Agreement, as they were two completely separate agreements. The NAFTA Parties had endeavoured to create transparent and objective rules of origin based on changes in tariff classification. That effort would be continued in relation to chemical rules of origin, an area which offered an opportunity to see if it was possible to move forward, as was the general desire of all three Parties. The NAFTA Parties hoped and believed that the NAFTA was trade-creating.

35. The representative of the NAFTA further said that an interesting point had been raised in terms of trade creation versus trade diversion. He recalled that the representative of the European Communities had said that a free-trade area carried the obligation to be trade-creating, not only on an overall basis, but also within each sector, and that it should extend the benefits of that trade liberalization directly to the good. However, the NAFTA Parties' view was that, as the trade statistics for 1994 showed, and as it seemed those for 1995 would substantiate, overall trade within the NAFTA had gone up by about 17 per cent, which represented a significant increase. At the same time, imports from outside the NAFTA region had also gone up significantly, so there was no *a priori* evidence of trade diversion. The rules of origin could not be examined in isolation; the effects of the NAFTA as a whole should be considered, and there was no evidence that could suggest that the trade-diverting impacts were overwhelming, or even offsetting any trade creation effects. In reply to the comment on the textile rules of origin, he said that the textile rules of origin were very clear as to what was required. They were based on tariff classification in virtually all cases. In the case of the automotive sector, the NAFTA Parties had endeavoured to provide as much transparency and predictability as possible with regards to the rules of origin. The primary objective had been to get an accurate count for a value content test. A conclusion had been that a regional value content test for aircraft was not necessary. In the future, the NAFTA Parties might or might not be able to come to that conclusion regarding automotive products. However, one aspect of the automotive rule of origin of the NAFTA was unique: the rules did not operate on the principle of all or nothing. For example, if a semi-finished bearing was imported into the NAFTA area and was further processed, increasing the value of the bearing, the additional value would be counted as originating.

36. Another representative of the NAFTA noted that the points raised regarding questions 58 and 88 were not new issues: with respect to the textile rules of origin, similar concerns had been raised before. It was his understanding that the Committee aimed to work towards consensus, and since there was no consensus on this point, he would like to emphasize some facts from the original reply, contained in document WT/REG/4/1. First, the textile rules of origin were based on fabric- or yarn-forward, rather than fibre-forward rules. In the answer to question 95 in the original document, there was some information on fibre forward issues, but with respect to its general application, ready-made clothing and other similar products must be produced in the NAFTA from NAFTA-originating yarn and fabric. The second point he wished to stress was that, in relation to question 58, the NAFTA Parties addressed the concerns raised by delegations. Flexibility had been provided, in the form of tariff preference levels. Yarn or fabric from third parties could be used to produce finished products which could qualify for a NAFTA tariff preference when exported within the NAFTA. He therefore urged delegations to look at the way the textile and apparel trade was treated as a whole within the NAFTA.

37. The representative of the NAFTA then replied to the hypothetical example raised by the Korean delegation. The company had a choice. Nothing could stop that company, or any other company, from trading at the MFN rates. However, if the company wished to benefit from the preferential rates available under NAFTA, it would have to meet the NAFTA rules of origin. The NAFTA provided a choice and an opportunity, subject to certain rules.

38. The representative of the European Communities said that his delegation's reading of Article XXIV:5(a) and (b) was that, while the words "on the whole" appeared in (a), relating to the trade regime in the context of the examination of a customs union, these words were absent in subparagraph (b). It seemed to pose no problem to raise particular questions about sectors according to the underlying rule. The Committee had linked some of those questions to the general debate on what meaning might be given to Article XXIV:4. In doing so, the Committee had strayed from both the Article itself and the Committee's Terms of Reference. He added that he agreed entirely with the NAFTA Parties that the question of the comparison between the existing NAFTA and, in part, the previous Canada-United States Free Trade Agreement, was a systemic issue which needed to be addressed in the future. Article XXIV:5(b) provided that duties and other regulations of commerce "shall not be higher or more restrictive, than the corresponding duties and other regulations of commerce, existing in the *same* constituent territories *prior to* the formation of the free-trade area, or interim agreement, as the case may be." This could be read to mean that the proper basis for comparison, where there had been a prior free trade agreement, would include the prior arrangements. The words "same constituent territories" were not qualified by an assumption that there had been no other previous preferential arrangement, and "prior" did not assume a sort of perfect, most-favoured-nation world. There were complications, and he did not wish to prejudge the outcome of the debate by drawing any definite conclusions as to what the interpretation ought to be.

39. The representative of the NAFTA noted that the phrase "on the whole" in Article XXIV:5(a) reflected a recognition that the formation of a customs union might result in the increase of restrictions and certain tariff rates vis-à-vis third parties. This point should be recognized in any further discussion on systemic issues. The point raised on the interpretation of Article XXIV:5(b) should also be included in the overall systemic discussion. The Article mentioned internal regimes, not arrangements, and this merited further discussion.

40. The representative of Korea requested an explanation as to why the passenger-carrying capacity should be a criterion for the different rates of local content for automobiles. In referring to the hypothetical automotive example, he said that, while the automotive company might have a choice, his delegation nevertheless wished to point out that the choice was a very difficult one.

41. The representative of the NAFTA explained that the content level for passenger vehicles was 2.5 per cent higher than the level for heavy-duty vehicles as a result of a negotiation process. During the negotiations, it seemed that the different features of a heavy-duty truck made 6.25 per cent an appropriate content level for ordinary passenger cars, but not for heavy trucks.

Chapter Five: Customs Procedures

42. The representative of Switzerland said that Mexico's use of two customs valuation systems, based on the provenance of the goods, continued to raise some doubts. The replies given by the NAFTA Parties did not justify such a differentiated practice under Article XXIV.

43. The representative of the European Communities said that his delegation, too, remained concerned over the changes in the Mexican customs valuation arrangements undertaken since the NAFTA's entry into force. The matter would be taken up in other WTO fora.

44. The representative of Australia referred to the answers to questions 103 and 105 in the Addendum and said that a change from f.o.b. to c.i.f. valuation, without a consequent downward adjustment in *ad valorem* tariff rates, had to affect the trade of third parties.

45. The representative of Japan, in supporting the position articulated concerning Mexico's change from f.o.b. to c.i.f., said that, while neither system was illegal under WTO rules, the change by the Mexican Government of the long-established f.o.b. to c.i.f. nevertheless had a *de facto* tariff increase effect on non-NAFTA countries. It was a non-negligible effect, because most of the non-NAFTA countries were located at great distance from the NAFTA and also because the f.o.b. system continued to be applied for NAFTA-originating products. The change could be inconsistent with Article XXIV:5(b) if the resulting *de facto* tariff increases to non-NAFTA countries had been intentional. If not, the Mexican Government should give a full explanation of the purpose of the change, and the reason it took place at the time of the establishment of the NAFTA.

46. The representative of Mexico replied that the c.i.f. valuation system should not be interpreted as a *de facto* tariff increase. If it were to be interpreted that way, all WTO Members applying a c.i.f. system should be considered as having higher tariffs than those applying the f.o.b. system. Article VIII of the Customs Valuation Agreement deemed both systems as acceptable and valid. The c.i.f. system as applied by Mexico did not change the nature of Mexico's schedule of concessions. The c.i.f. system had been in force since 1994 and was thus already applicable when the schedules of concessions of Mexico came into force. This had no direct relation to the MFN tariffs, which continued unchanged, regardless of the system applied. It was clear that no protection was intended, as the MFN tariffs applied by Mexico were lower than those which Mexico was entitled to apply in accordance with the bound levels. He raised the issue not in terms of consistency, but rather to show that there was no intention of protecting domestic industry. In their capacities as individual WTO Members, Canada, Mexico and the United States had each opted to apply the c.i.f. system in the multilateral trade. However, for products originating in North America, the NAFTA Parties all applied f.o.b. The NAFTA, unlike the European Communities, was not a Member of the WTO. The choice of f.o.b. was a purely temporary solution whose application was intended for the transitional period moving towards free trade in North America. At the end of the transitional period, when a zero duty system would prevail, c.i.f. or f.o.b. would be irrelevant. The f.o.b. system could be considered as a marginal acceleration of the time-frame that the NAFTA Parties had in mind for decreasing tariffs. For administrative and practical reasons it had been decided to use the f.o.b. system, rather than to accelerate the decrease in tariff rates. The same practical results would be obtained, whether the NAFTA provided for an acceleration of the decrease in tariff rates or whether it switched from the c.i.f. to the f.o.b. system.

Chapter Six: Energy and Basic Petro-chemicals

47. The representative of the European Communities wondered if there was anything the NAFTA Parties wished to add to the answer provided to supplementary question 106, which dealt with the situation when one NAFTA Party obliged or required other NAFTA Parties to apply export restrictions. He did not wish to imply that that situation would necessarily be inconsistent with WTO obligations, but merely wished to suggest that it could be. The reply did not entirely address the point.

48. The representative of the NAFTA replied that in the hypothetical case where provisions were being violated, a clear problem would arise, which would present a case of WTO-inconsistent actions. The NAFTA Parties had no intention of taking WTO-inconsistent measures.

49. The representative of the European Communities said that the response made it clear that there was a risk of an awkward circumstance where one NAFTA Party would in practice be responsible for the other Party's adherence to its obligations. That was clearly a matter for the Parties, themselves, to work out, but he wished to note the point.

Chapter Seven: Agriculture

50. The representative of Australia commented on the answers to supplementary questions 109, 113, and 118-120. When minimum access commitments were negotiated within the Uruguay Round, one of the bases of the commitments, designed to open up markets, had been that such commitments were to be carried out on an MFN basis. There was a problem in that the modest, initial quota arrangements were not allocated on an MFN basis, but rather in a way which took into account access through concessional, free trade, or other arrangements. Hypothetically, if a WTO member opened up a tariff quota of 100,000 tons and allocated that amount on an MFN basis, at an in-quota tariff rate of 20 per cent, and if some trading partners had a preference because of bilateral or plurilateral arrangements, it was difficult to understand how that could be construed as MFN, and why such trade should be included within the tariff quota. The Government of Australia was concerned that new MFN access, which had resulted from the Uruguay Round, had subsequently been reduced or eroded by the NAFTA partners. Counting such preferential trade against MFN access commitments posed a problem, particularly in the cases of sugar and skimmed milk powder. He noted that Canada, a Cairns Group country, appeared to have specifically, and correctly, excluded access for its NAFTA partners.

51. The representative of Argentina referred to the example given in the response to the first question on agriculture, regarding tariff-rate quota (TRQ) allocations. Was the formula used in the example applicable to *all* products which had TRQs?

52. The representative of the United States replied that, as far as the United States was concerned, the answer was yes.

53. The representative of Argentina wondered if the same would hold true for sugar. He referred to the United States Trade Policy Review, which had found there to be a special consideration on sugar, in terms of opening-up TRQs with a different methodology.

54. The representative of NAFTA clarified that Canada had most-favoured-nation TRQs under the Uruguay Round Agreement, and imports from all partners were counted, including the United States and Mexico, against those TRQ levels.

55. To explain how Mexico avoided double accounting, the representative of Mexico repeated the example provided in the response to the supplementary question on Agriculture.

56. The representative of Australia said that, given that each country had answered separately, it appeared as though the NAFTA Parties did not have a common view, and that the answer to the original question was still missing. Canada did not include sugar-arrangements under the NAFTA in its global quotas, but the United States and Mexico did. While sugar was not mentioned in the schedule, it nevertheless received this treatment in practice, which was not in accordance with the rules. The Agricultural Agreement and the modalities that went with it made minimum access requirements clear. Market access was to be granted on the basis of a tariff quota at a low or minimal rate and should be provided on an MFN basis.

57. The representative of the European Communities said his statement in relation to the original reply to question 113, remained of importance. Regarding the reply to original question 109, he said that it did not answer the question and his delegation looked forward to hearing a more definitive answer.

58. The representative of Mexico wished to comment on some of the questions and remarks made by the Australian representative. Mexico had made special provisions for the use of TRQs, following the rules laid down in Article XIII. If the MFN-clause was not followed, the provisions of Article XIII were applied. That was not limited to the case of free-trade areas, as a number of GATT countries had recognized during the Uruguay Round negotiations that they were in a similar situation. Was the Australian delegate referring to minimum access provisions? These were to be found in the Agricultural Agreement and Appendix 5 to the Agreement, not in Article IV on Tariffs. As for sugar, the distribution was based neither on Article XIII, nor on MFN. Those wishing to import sugar would have to pay duties before introducing the goods into the country. The only measure applied was the collection of customs duties.

59. The representative of Argentina referred to the answer to question 121, which stated that if the United States changed or suspended the allocation of market shares in accordance with Article XIII, it would promptly enter into consultations with Australia. The Argentinean delegation wished to see full application of Article XIII:5 in such cases, not only in those cases involving Australia.

60. The representative of Canada said that the NAFTA Parties had no intention to establish TRQs under their Agreement, except for those cases falling under the special safeguard provisions of Article 703:3. This Article had been referred to earlier in the context of the reply to question 29. TRQs had been treated under the Uruguay Round negotiations, and Canada did include imports from the United States and Mexico as counting against its TRQs.

61. The representative of Australia was of the view that Canada's TRQs were fair and consistent with the provisions of the Agreement on Agriculture.

Chapter Eight: Emergency Action

62. The representative of Korea recalled that at the meeting on the first NAFTA examination, he had asked why the NAFTA Parties considered Article 802 to be consistent with the GATT rules. The supplementary reply had not provided a detailed explanation. The tariff preferences under the NAFTA would naturally lead to increased imports of certain products originating within the NAFTA region, and that could, in turn, result in serious injury to Korean producers. The provisions of Article 302 of the NAFTA excluded the other two NAFTA Parties from the application of global safeguard measures imposed by one of the NAFTA Parties. In accordance with the spirit of GATT Article XIX, paragraphs 1(b) and 3(a), products imported from other partners of a preferential arrangement should be regarded as the most likely target when safeguard actions needed to be taken. It was probable that products imported from other partners of a preferential arrangement were a greater source of injury to domestic industry than products from a third country. Article 802 of the NAFTA seemed to attribute increases in imports caused by tariff preferences to sources outside the NAFTA area.

63. The representative of Japan supported the Korean delegation's intervention.

64. The representative of Australia did not disagree with the response to additional question 128, but said that the response did not address the question of how injury was assessed in an Article XIX situation.

65. The representative of the European Communities said he was puzzled by three words in the response provided to supplementary question 128. The response stated that the exclusion from another NAFTA Party's application of a global safeguard action "under certain circumstances" did not conflict with Article XIX of the WTO Agreement on Safeguards, when considered in the context of a free trade agreement under GATT Article XXIV. What were those circumstances? In what circumstances would the NAFTA Parties view such measures to be in conflict?

66. The representative of the NAFTA said that the provisions of Article 802 were consistent with the provisions of Article XXIV of the GATT, inasmuch as Article XXIV provided for a removal of trade barriers. In addition, the exception in favour of other Parties of the NAFTA applied only when the imports of such members were of significant volume as compared with other imports. There seemed to be a misunderstanding as to the meaning of the words "under certain circumstances". Only in the case where the imports from another Party were significant did the safeguards apply. Safeguards could not apply for lesser quantities in the free-trade area. Even though in certain instances the NAFTA safeguards system could conflict with GATT Article XIX, the Agreement was, on the whole, consistent with WTO Rules.

67. The representative of the European Communities asked whether the explanation meant that the NAFTA rules were applied differently according to the volume of imports? He wondered what the words "under certain circumstances" meant in terms of the conflict of rules, not in terms of the circumstances in which the NAFTA Parties made use of the safeguard provisions themselves.

68. The representative of the NAFTA said that there was no overall conflict between the provisions of the NAFTA and those of the WTO. The exception was applicable under the NAFTA itself, in specific cases when the volumes of imports were not significant. With respect to the provisions of GATT Article XXIV, which provided for the elimination of trade barriers among members of a free-trade area, it was acceptable to have safeguard measures which were specific to the members of the free-trade area. He stressed that under the NAFTA provisions, the volumes of imports affected were relatively insignificant.

69. The representative of Japan wondered which paragraph of Article XXIV could justify the NAFTA safeguard measures.

70. The representative of the European Communities said that the problem of safeguards was particularly difficult and important because, as the NAFTA response set out, it addressed not only the relationship between the NAFTA provisions and the circumstances in which they applied, but also the relationship between those provisions and the full compass of WTO rules. The issue involved the relationship between GATT Articles XIX and XXIV, and the WTO Understanding on Safeguards.

71. The representative of Hong Kong wondered whether the safeguards thresholds, under which the members of NAFTA would be excluded from the action, also applied to non-NAFTA Members. His second question referred to anti-dumping measures. Did the NAFTA exclude the application of anti-dumping measures among its members? How would the NAFTA Members justify the fact that safeguards could be excluded on the basis of Article XXIV:5(a), but at the same time, anti-dumping remained separate? What was the rationale, economic or otherwise, for the approach to the application of trade remedies?

72. The representative of the NAFTA took up the question put forth by the Japanese delegation. Article XXIV:8(b) stated that there should be a substantial elimination of tariffs and other restrictions to trade in a free-trade area. Since safeguard measures presumably constituted a restriction to trade, adopting an exception for members of a free-trade area would be entirely in keeping with the specific provision of Article XXIV. In light of the concerns repeatedly expressed by the European Communities over the three words "under certain circumstances," the NAFTA Parties could perhaps amend the drafting so that the language became entirely clear. NAFTA Article 802 provided for the exclusion of other NAFTA Parties from the application of global safeguard actions in circumstances in which trade volumes were insignificant. In the view of the NAFTA Parties, this exclusion did not conflict with GATT Article XIX or other provisions of the WTO. Article XXIV was not restricted to the elimination of tariff barriers, but dealt with the elimination of regulations in general; elimination of restrictions exclusively among the members of a free trade agreement was in keeping with the Article. Regarding the question on anti-dumping, the NAFTA covered anti-dumping in Chapter 19. Rather than providing for a common regime, the provisions allowed each Party to retain its own domestic anti-dumping laws.

73. The representative of Argentina called attention to Article 12, paragraph 3, of the Agreement on Sanitary and Phytosanitary Measures, which referred to the need for a harmonization process, that took into account those measures which had the greatest trade impact. He recalled a discussion in the Committee on Sanitary and Phytosanitary Measures which had taken place a couple of years ago regarding the definitions of greatest trade impact and minimal trade impacts. No conclusions had been reached. It was necessary, when considering maximum or minimal impacts, to take into account the country considered; was it the impact on a country like the United States, or a country like Haiti? It was worth bearing in mind that a rule based on what might constitute marginal effects would systematically be rejected in dispute settlement, as had been recognized in the recent Tobacco Panel.

74. The representative of the European Communities said that the Committee might need to return to the issue of NAFTA safeguards.

75. The representative of Japan maintained the view that safeguard measures that excluded only the NAFTA countries risked being inconsistent with the MFN principle. Could the NAFTA Parties provide more reasonable justifications?

76. The representative of the NAFTA asserted that Article XXIV:8(b) contained an obligation to eliminate tariffs and other restrictive regulations of commerce, except those permitted under Articles XI, XII, XIII XIV, XV and XX. Article XIX was not mentioned in Article XXIV:8(b). This had given rise to many discussions and proposals during the Uruguay Round and there had been no clear solution to the problem. Perhaps that was why the Safeguards Agreement had a footnote stating that there was no prejudging priority as to Article XIX or Article XXIV. If one were to interpret Article XXIV:8(b) stipulating that restrictive regulations be eliminated and as purposefully not mentioning Article XIX, then the NAFTA Parties were justified in excluding each other when applying global safeguards under NAFTA Article 802. However, when negotiating that Article, the NAFTA Parties had taken the interests of other WTO Members into account and had decided that such exclusion should not take place when another NAFTA Party's trade represented a substantial volume or made a significant contribution to injury. The NAFTA text was thus less restrictive than it would have been, had it followed the strict letter of Article XXIV:8(b). That drafting was now being interpreted as being in conflict with WTO obligations to some extent, even though the NAFTA Parties had actually gone above and beyond their obligations as WTO Members. He agreed with the representative of the European Communities that the matter was still open, and said that as these sorts of measures were new, the Committee would not be able to conclude its discussions at this meeting.

77. The representative of the European Communities said that his delegation had not offered any observations on whether the NAFTA was in conflict with anyone's obligations under the WTO.

Chapter Nine: Standards Related Measures

78. The representative of the European Communities sought clarification on the reply to supplementary question 129. According to his delegation's interpretation of the response, measures targeted toward the legitimate objectives, listed in Article 904.2 of the NAFTA, would only be used to underpin measures taken in relation to other NAFTA Parties. This meant that the rights and obligations of third countries would not be adversely affected, and the result would be a sort of *de facto* reverse discrimination, if the measure was carried through. It was conceivable that more onerous provisions would apply to trade between the NAFTA Parties than between any NAFTA Party and third countries. If that understanding was correct, then that point would be satisfactorily disposed of.

79. The representative of the NAFTA said that the rights and obligations of NAFTA members were governed by NAFTA's Chapter Nine on this particular point. If the NAFTA Parties undertook obligations that went beyond their WTO obligations, it was debatable whether that should be subject to examination in the Committee. Question 129 dealt exclusively with provisions applicable to the United States, Canada and Mexico.

80. The Committee took note of the statements made and agreed to continue its examination at a later stage.