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Antidotes to Regionalism: Responses to Trade Diversion Effects of the North American Free Trade Agreement*

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I. Introduction

On December 17, 1992, the heads of state of Canada, Mexico, and the United States signed the North American Free Trade Agreement (NAFTA).[1] The governments of all three countries have agreed to a timetable whereby their respective legislatures will consider the NAFTA by August, 1993.[2] If those legislatures approve the NAFTA, then, subject to exchange of written notifications certifying completion of each respective country's legal procedures, the NAFTA will enter into force on January 1, 1994.[3]

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[1] North American Free Trade Agreement, Dec. 17, 1992, Can.-Mex.-U.S. [hereinafter NAFTA].

[2] U.S. President Bill Clinton has stated his support for the NAFTA, but also has stated that he "will not sign legislation implementing the North American Free Trade Agreement until [the United States has] reached additional agreements to protect America's vital interests," particularly its environmental and labor interests. Governor Bill Clinton, Expanding Trade and Creating American Jobs, Address at North Carolina State University (Oct. 4, 1992); *see also* John Maggs, *Clinton Faces Sacrifices in Bid to Reopen Talks*, J. Com., Dec. 3, 1992, at 1C. The United States Trade Representative has suggested adding supplementary rules—not simply changing the existing text.

Top U.S., Canadian, and Mexican trade negotiators have begun negotiating the supplementary texts and have agreed to try to finish negotiations by this July. *See Negotiators of NAFTA Side Pacts Set Timetable to Finish Work by Summer*, 11 Inside U.S. Trade, No. 11, Mar. 19, 1993, at 1.

[3] NAFTA, *supra* note 1, art. 2203.

Successful adoption and implementation of the NAFTA (and any supplementary agreements) by the legislatures of the three North American countries would create the world's largest free-trade area, comprised of a market of 360 million people and 6.5 trillion dollars in annual production.[4] The agreement will have a significant impact on business in all three member countries, as well as on trade relations between NAFTA member countries and their trading partners throughout the world.

Several U.S. commentators believe that the implementation of the NAFTA is advantageous to both the United States and Mexico. One argument focuses on the economic advantages to North America.[5] Because the NAFTA will eliminate tariff and non-tariff barriers to trade such as restrictive quotas, licenses, and technical barriers, some economists argue that the principle of comparative advantage will operate to ensure that North American consumers may choose the most efficiently produced goods, regardless of whether they are made in Canada, Mexico, or the United States. This result will benefit those U.S. industries, agricultural producers, and service providers that are relatively efficient, but will hurt those businesses that are relatively inefficient.[6]

A second contention centers on the idea that the NAFTA will help Mexico by expanding its trade and development opportunities, which in turn may stabilize Mexico's democratic and free-enterprise oriented government. Such arguments are rooted in an extensive body of theoretical and historical literature that contends that economic devlopment contributes to the development of democracy.[7]

Third, some commentators have argued that the NAFTA may stem the flow of economic refugees from Mexico who enter the United States as undocumented aliens.

In contrast, others have argued that entry into the NAFTA

[4] U.S. CHAMBER OF COMMERCE, A GUIDE TO THE NORTH AMERICAN FREE TRADE AGREEMENT: IMPLICATIONS FOR U.S. BUSINESS at xi (1992).

[5] *See, e.g.*, INTERNATIONAL TRADE COMMISSION, POTENTIAL IMPACT ON THE U.S. ECONOMY AND SELECTED INDUSTRIES OF THE NORTH AMERICAN FREE-TRADE AGREEMENT, USITC Publication 2596 (1993); GARY C. HUFBAUER & JEFFREY J. SCOTT, NAFTA: AN ASSESSMENT (1993).

[6] On the operation of comparative advantage, see generally DAVID RICARDO, *On the Principles of Political Economy and Taxation*, *in* WORKS AND CORRESPONDENCE 133-49 (Piero Straffa ed., 1951); CHARLES P. KINDLEBERGER & PETER LINDERT, INTERNATIONAL ECONOMICS (6th ed. 1978). *See also* EMILE DURKHEIM, THE DIVISION OF LABOR IN SOCIETY 227-33 (George Simpson trans., 1947).

[7] *See, e.g.*, SEYMOUR MARTIN LIPSET, POLITICAL MAN (2d ed. 1983).

may be inadvisable because of concerns about its effect on both U.S. labor and the environment. Some economists predict that as a result of the NAFTA, U.S. wages will fall and the United States will lose jobs to Mexico.[8] Some environmental groups are concerned that without further safeguards, the NAFTA will provide opportunitites for corporations to escape relatively stringent U.S. environmental standards by moving to Mexico, where some environmental standards may be lower and enforcement relatively lax.[9]

Regardless of whether the NAFTA is considered advantageous to North America, its expected impact on Asia is engendering widespread anxiety there. The economic ministers of the Association of Southeast Asian Nations (ASEAN)[10] expressed concern that the NAFTA might become an exclusionary regional economic bloc.[11] Malaysian[12] and South Korean officials have expressed similar concerns about the NAFTA's potentially disadvantageous effect on their economies.[13] The Japanese have been particularly vocal in expressing their concern that the NAFTA is protectionist and will have a negative impact on Japan's trade with North America. For example, Japanese Prime Minister Kiichi Miyazawa recently voiced concern that the NAFTA could turn North America into a "fortress" against goods from abroad.[14] Similarly, Hiroshi Hirabayashi, the Deputy Chief of Mission at the Japanese Embassy in Washington, D.C., has argued that several NAFTA provisions "raise barriers to outside countries."[15] Perhaps the most direct criticism has come from Japanese International Trade and Industry Minister Kozo

[8] *See, e.g.*, Timothy Koechlin & Mehrene Larudee, *The High Cost of NAFTA*, 35 CHALLENGE, No. 5, Sept.-Oct. 1992, at 19; EDWARD E. LEAMER, WAGE EFFECTS OF A U.S.-MEXICAN FREE TRADE AGREEMENT (National Bureau of Economic Research Working Paper No. 3991, Feb. 1992).

[9] *See, e.g.*, INSIDE U.S. TRADE, Special Report, Feb. 5, 1993, at S1-S8.

[10] ASEAN includes Thailand, Singapore, Brunei, Malaysia, Indonesia, and the Philippines.

[11] *See ASEAN, Japan to Express Concern Over NAFTA*, Japan Economic Newswire, Oct. 22, 1992, *available in* LEXIS, Nexis Library, JEN File; *Japan Voices Concern on Exclusionary Nature of NAFTA*, Japan Economic Newswire, Oct. 17, 1992, *available in* LEXIS, Nexis Library, JEN File.

[12] *Japan to Oppose NAFTA at APEC Meeting*, Agence France Presse, Sept. 7, 1992, *available in* LEXIS, Nexis Library, AFP File.

[13] *ROK and Japan to Promote Asia-Pacific Economic Cooperation as Response to NAFTA*, British Broadcasting Corporation, Summary of World Broadcasts, Nov. 12, 1992, *available in* LEXIS, Nexis Library, BBC SWB File.

[14] Jim Mann, *Japanese Express Concern Over Free Trade Pact*, L.A. TIMES, Dec. 28, 1992, at D2.

[15] *Id.*

Watanabe, who stated his opposition not only to the NAFTA, but to "regionalism and protectionism in all cases."[16]

To quell anxiety regarding the NAFTA, former Deputy U.S. Trade Representative Julius Katz has stated that any such disadvantageous effects on foreign markets will be minimal.[17] Moreover, Canadian Prime Minister Brian Mulroney claims that the Agreement will eventually benefit Japan.[18] Nevertheless, concerns of the potential impact of the NAFTA on Asia persist.

The NAFTA's impact on Asia is particularly significant. From an economic standpoint, with the elimination of tariff and nontariff barriers in North America, relatively inexpensive Mexican labor will likely displace some labor-intensive Asian production of goods bound for the United States. From a political standpoint, these "trade diversion" effects on Asia could contribute to political-economic tension between North America and Asia and help catalyze a process of dissolution of the world trading system into regional trade blocs.

This article will analyze the impact that the NAFTA may have on Asia and the structure of world trade, and will suggest ways to minimize adverse effects. Part II will discuss how existing economic and political theories assess the effects of regional trade arrangements on the global political economy. Part III will analyze the extent to which the NAFTA will in fact divert trade from Asia, focusing on seven sectors that are vital to Asian industry: textiles, automobiles, light trucks, automobile parts, electronics, toys, and steel. Part IV will consider current international legal treatment of trade diversion from free trade agreements and will suggest legal rules and strategies for reducing trade diversion. Part V will conclude by suggesting an approach for ameliorating the negative effects on the global political economy of regional free trade agreements.

II. ANALYZING THE TRADE DIVERSION EFFECTS OF FREE TRADE AGREEMENTS: ECONOMIC AND POLITICAL APPROACHES

A. *Traditional Economic Approaches and the Evolution of Free Trade Agreements*

No economic theory of trade has been more dominant in the

[16] *Japan to Oppose NAFTA at APEC Meeting*, *supra* note 12.

[17] Ambassador Julius Katz, Remarks at the Foreign Press Center Briefing (Aug. 26, 1992) (transcript on file with the *Stanford Journal of International Law*).

[18] *See NAFTA to Benefit Japan: Mulroney*, Jiji Press Ticker Service, Dec. 22, 1992.

last two centuries than David Ricardo's theory of comparative advantage.[19] Ricardo's theory suggests that free trade between two countries will improve economic efficiency and maximize consumer welfare in both countries. Thus, the theory suggests that trade liberalization is good. Similarly, prior to the appearance of Jacob Viner's classic 1950 analysis of customs unions,[20] the literature on regional trade liberalization was "almost universally favorable to them."[21] This view apparently was shared by those negotiating the Havana Charter for an International Trade Organization (Havana Charter).[22] Article 44 of the Havana Charter states that "Members [of the International Trade Organization] recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements."[23] The authors of Article 44 viewed these trade blocs or regional arrangements as stepping stones to subsequent multilateral liberalization.

Viner cast serious doubt on the net economic benefit of creating a free-trade area or customs union.[24] According to Viner, both "trade creation" and "trade diversion" result from the formation of a customs union or free-trade area in which intra-re-

[19] *See* RICARDO, *supra* note 6.

[20] JACOB VINER, THE CUSTOMS UNION ISSUE (1950).

[21] *Id.* at 41; *see* GOTTFRIED VON HABERLER, THE THEORY OF INTERNATIONAL TRADE 383-91 (1936); Gottfried von Haberler, *The Political Economy of Regional or Continental Blocs*, *in* POSTWAR ECONOMIC PROBLEMS 330-34 (Seymour E. Harris ed., 1943); John de Beers, *Tariff Aspects of a Federal Union*, 56 Q.J. ECON., Nov. 1941, at 49.

[22] The Havana Charter was the primary instrument resulting from the United Nations Conference on Trade and Employment. The Charter, which had over fifty signatories, would have created the International Trade Organization (ITO). The Charter never entered into force, however, in large part because the United States (which was a signatory) eventually decided not to accept it. U.S. refusal to accept the Charter was due in part to Congressional concerns over Havana Charter provisions relating to restrictive business practices. The General Agreement on Tariffs and Trade (GATT) was intended to serve as a temporary regime until the ITO could be formed. *See generally* JOHN H. JACKSON, WORLD TRADE AND THE LAW OF GATT (1969).

[23] *Charter for an International Trade Organization*, Mar. 24, 1948, U.N. Doc. E/CONF.2/78, *reprinted in* U.S. DEP'T OF STATE, PUB. NO. 3117, COM. POL. SER. 113 (1948).

[24] A free-trade area is a group of two or more customs territories in which the duties and other restrictive regulations of commerce are eliminated on all or most of the trade between the constituent territories on products originating in such territories. A "customs union" has the above-described attributes of a free-trade area, yet in addition, the constituent territories become a single customs territory where members of the union apply substantially the same duties and other regulations of commerce as are applied to trade from territories outside the union. For definitions, see, e.g., General Agreement on Tariffs and Trade (GATT), Oct. 30, 1947, art. XXIV, para. 8, 55 U.N.T.S. 187, 268 (1950). The current version is contained in GATT, 4 BASIC INSTRUMENTS AND SELECTED DOCUMENTS 43 (1969) [hereinafter BISD].

gional trade barriers are eliminated. Viner described trade creation as a positive, efficient result of free trade. He argued that with trade creation:

> There will be commodities . . . which one of the members of the customs union will now newly import from the other but which it formerly did not import at all because the price of the protected domestic product was lower than the price at any foreign source plus the duty. This shift in the locus of production as between the two countries is a shift from a high-cost to a lower-cost point, a shift which the free-trader can properly approve, as at least a step in the right direction, even if universal free trade would divert production to a source with still lower costs.[25]

In contrast, Viner described trade diversion as a negative, inefficient result of free trade. He claimed that with trade diversion:

> There will be other commodities which one of the members of the customs union will now newly import from the other whereas before the customs union it imported them from a third country, because that was the cheapest possible source of supply even after payment of duty. The shift in the locus of production is now not as between the two member countries but as between a low-cost third country and the other, high-cost, member country. This is a shift of the type which the protectionist approves, but it is not one which the free-trader who understands the logic of his own doctrine can properly approve.[26]

According to Viner, whether the establishment of a regional trading bloc is a net benefit to the world economy depends upon which force predominates—trade creation or trade diversion.[27] Viner identifies seven factors that may indicate "what the over-all balance between these conflicting considerations would be."[28] Building on Viner's analysis, others have tried to identify additional factors to determine whether the establishment of a particular regional bloc has resulted in net trade diversion or net trade creation.[29] Beyond identifying general factors, however, no

[25] VINER, *supra* note 20, at 43.

[26] *Id.*

[27] *Id.* at 44.

[28] For the purposes of the present analysis, only the first two factors identified by Viner are particularly relevant: (1) trade creation increases as the size of the regional bloc increases, enabling a greater potential scope for internal division of labor; and (2) trade diversion decreases as the average tariff level on imports from outside the region decreases. *Id.* at 51-52.

[29] *See, e.g.*, JAMES E. MEADE, THE THEORY OF CUSTOMS UNIONS (1955); TIBOR

economist has been able to determine *a priori* whether trade creation or trade diversion predominates in the formation of a regional bloc. Even in formal, detailed economic analyses of specific regional formations, determinations as to whether trade creation or trade diversion predominates usually have been unsuccessful[30] or expressed only as a broad and speculative "suspicion."[31]

In the two or more decades since these analyses were undertaken, new factors have appeared in trade negotiations that further complicate the analysis of whether regional trade agreements benefit the global economy by resulting in net trade creation, or whether they disadvantage it by creating net trade diversion. Regional trade agreements now address not only the elimination of intra-regional tariffs and quantitative restrictions, but also issues such as intra-regional liberalization of cross-border transportation barriers,[32] intra-regional standardization and harmonization of technical standards,[33] sanitary and phytosanitary regulations,[34] intra-regional services trade liberalization,[35] and intra-regional intellectual property standards.[36] In order to incorporate these modern factors into analyses of whether trade creation or trade diversion would result from a regional trade agreement, Viner's analytical framework must be modified.[37]

Even if such modifications were made, however, applying the Viner trade diversion/trade creation model to determine whether a particular free trade area or customs union benefits the world economy remains a complex task. Application of the

SCITOVSKY, ECONOMIC THEORY AND WESTERN EUROPEAN INTEGRATION (1958); Kenneth W. Dam, *Regional Economic Arrangements and the GATT: The Legacy of a Misconception*, 30 U. CHI. L. REV. 615 (1963).

[30] *See, e.g.*, SCITOVSKY, *supra* note 29, at 60, 68-78.

[31] *See* Dam, *supra* note 29, at 657-58.

[32] *See, e.g.*, Commission Regulation 1841/88 of June 21, 1988 on Community Quotas and Free Road Transport Market, 1988 O.J. (L 163) 1; Council Directive 89/438 on Access to the Road Haulier Profession, 1989 O.J. (L 212) 101.

[33] *See, e.g.*, EC Council Resolution 136/01 on New Approach to Technical Harmonization and Standards, 1985 O.J. (C 136) 1; Council Directive 89/392 on Standards for Machinery, 1989 O.J. (L 183) 9.

[34] *See, e.g.*, Council Directive 89/109 on Materials and Articles Coming Into Contact with Food, 1989 O.J. (L 40) 89.

[35] *See, e.g.*, Proposed Second Council Directive 84/01 on the Regulation of Credit Institutions, 1988 O.J. (C 84) 1; First Council Directive 73/239 on Non-Life Insurance, 1973 O.J. (L 228) 3; EC Proposed Directive on Investment Services in the Securities Field 43/10, 1989 O.J. (C 43) 7.

[36] *See, e.g.*, EC Proposed Regulation on a Community Trade Mark, COM(84)470; 1984 O.J. (C 230) 1; Community Patent Convention, 1976 O.J. (L 17) 1; Council Directive 87/54 on Legal Protection of Topographies of Semiconductors, 1987 O.J. (L 24) 36.

[37] The details of such a modification are beyond the scope of this article.

model requires an analysis of relative prices, elasticities, and quantities of every product traded internationally before and after establishment of a regional arrangement. Thus far, it has proven nearly impossible to determine definitively and precisely whether trade creation or trade diversion predominates as a result of establishment of any particular regional trade agreement.

B. *A Political Approach to the Regionalism Issue*

From a political viewpoint, whether a regional trade bloc results in a net economic benefit to the world economy may be of little consequence. Many scholars and historians adhere to the realist school, which focuses on the distribution of power capabilities of nations in the international system and argues that what matters to nation-states is whether a particular policy or action results in relative gains or losses of economic power among nations.[38] Viewed from that perspective, countries outside a free-trade region will be unhappy about the region's creation for at least two reasons.

First, even if trade creation, rather than diversion, predominates, the world outside the regional trade area "loses [market access and associated trade revenues], in the short-run at least, and can gain in the long-run only as a result of the general diffusion of the increased prosperity of the [regional trade] area."[39] The outside world will not gain any increased market access as a result of creation of the regional bloc; its only immediate experience will be a loss of markets within the region to the extent of any trade diversion. Thus, one would expect that most nations will not favor the creation of a regional trade bloc which they cannot join.[40]

Second, trade diversion in a free-trade area or customs union

[38] *See, e.g.*, KENNETH N. WALTZ, THEORY OF INTERNATIONAL POLITICS 97-99 (1979). *See generally* HANS MORGENTHAU, POLITICS AMONG NATIONS (1966).

[39] VINER, *supra* note 20, at 44.

[40] Countries outside the region will not always oppose the creation of the regional bloc, and may even support it in exceptional circumstances. For example, the United States supported the creation of the European Coal and Steel Community (ECSC), and later, the European Economic Community (EEC). *See generally Reports of Sub-Group on Rome Treaty*, 6S BISD 70 (1958); *Report by the Intersessional Committee*, 7S BISD 69 (1959); *Action at the Thirteenth Session*, 7S BISD 71 (1959). The United States was willing to bear the economic costs of the resulting trade diversion in order to reap the geo-strategic benefits of Western European economic unity, which would act as a bulwark against the Soviet Union. In terms of hegemonic stability theory, this may be a special case. Perhaps only a hegemonic power can afford the luxury of such an evaluation. *See* ROBERT GILPIN, WAR AND CHANGE IN WORLD POLITICS 141 (1981); Stephen Krasner, *State Power and the Structure of International Trade*, 28(3) WORLD POL. 317 (1977).

may become magnified if interest groups within the region attempt to balance the hardships of intra-regional trade creation (e.g., loss of jobs and profits by a higher-cost firm in one member country to a lower-cost firm in another member country) by deliberately pursuing protectionist policies that exacerbate trade diversion in order to yield more production within the region.[41] This may take place by means of discriminatory non-tariff barriers to extra-regional trade. These include the adoption of special sanitary or phytosanitary regulations for the region;[42] the adoption of measures ensuring a minimum proportion of culturally indigenous television or movie programming;[43] and the maintenance of a tariff wall against non-regional goods in order to ensure that such goods are supplied from within the region.[44] Perhaps the most pervasive means of exacerbating trade diversion in recent years has been the calculated manipulation of a region's rules of origin.[45] Such actions are sure to increase the international political tension resulting from the creation of a free-trade area or customs union.

More broadly, analysts of the international political economy may be concerned about the tendency for trade patterns and

[41] The United States has been concerned about the possibility that the EC might "turn inward" and adopt protectionist policies for the European region. *See* European Economic Integration (1992), Testimony by Carla A. Hills, U.S. Trade Representative, before the Senate Comm. on Finance (May 10, 1989) (transcript on file with the *Stanford Journal of International Law*); Carla A. Hills, The EC and a Single Integrated Market By 1992: Opportunity and Challenge, Address before the Chicago Council on Foreign Relations World Trade Conference (Apr. 12, 1989) (transcript on file with the *Stanford Journal of International Law*).

[42] For example, the United States accused the EC of manipulating its meat inspection standards (via the EC Third Country Meat Directive) without a bona fide scientific basis, in order to prohibit the importation of U.S. beef and pork into the Community. *See Hills Accepts Section 301 Case on EC Pork, Beef Ban, But Seeks Informal Solutions*, 9 INSIDE U.S. TRADE, No. 2, Jan. 11, 1991, at 4-5.

[43] For example, the United States has accused the EC of adopting its Broadcast Directive (which limits the proportion of non-EC produced programming that can be aired in Europe) for essentially protectionist purposes. *See Administration Warns EC It Will Request GATT Panel on Broadcast Directive*, 7 INSIDE U.S. TRADE, No. 41, Oct. 13, 1989, at 1; *see also* European Economic Integration (1992), *supra* note 41, at 10-11.

[44] For example, the EC maintains a prohibitive common external tariff and quotas on most agricultural products. For a discussion of recent progress in reducing those tariffs and quotas, see, e.g., *E.C. Commission Says Farm Deal with U.S. Legitimizes CAP Under GATT Rules*, INSIDE U.S. TRADE, Special Report, Dec. 4, 1992, at S-2.

[45] The United States has attacked the EC's use of rules of origin for allegedly discriminatory purposes with respect to at least two products: semiconductors and photocopiers. Both of these disputes erupted in 1989, in response to EC rules of origin regulations issued in February 1989. *See* Hills, European Economic Integration (1992), *supra* note 41, at 8-11; *see also Semiconductor Industry Fears EC Laws May Block U.S. Sales*, 7 INSIDE U.S. TRADE, No. 11, Mar. 17, 1989, at 13-14. Rules of origin will be discussed in later sections.

trade relations to become increasingly concentrated within a particular free-trade region. Concern over such concentrations stems from both the trade diversion and trade creation mechanisms. While the former reduces member state trade with countries outside the region, the latter makes members of the region increasingly dependent on each other by increasing the proportion of goods and services consumed in each member state that were produced in another member state. These effects combine to heighten intra-regional interdependence and to create a greater community of interest among the members of the region than previously existed, while simultaneously reducing interdependence and a community of interests between members and non-members.[46] These effects may evoke a regional response by countries outside the region.[47]

Many scholars believe that the post-war international trading system may be fracturing slowly into blocs.[48] Policy-makers find evidence of this development in the growing frequency and intensity of U.S. bilateral trade disputes with the European Community (EC) and Japan, and in the difficulties associated with the conclusion of the Uruguay Round of General Agreement on Tariffs and Trade (GATT) negotiations.[49] Other developments also

[46] For a discussion of extreme levels of dependence resulting from regional trade patterns, see generally ALBERT O. HIRSCHMAN, NATIONAL POWER AND THE STRUCTURE OF FOREIGN TRADE (1980). Conversely, for a discussion of multilateral interdependence, see generally ROBERT O. KEOHANE & JOSEPH S. NYE, POWER AND INTERDEPENDENCE (1977).

[47] In fact, Japan and South Korea have called for growth of the Asia-Pacific Economic Cooperation (APEC) organization to protect their interests against other economic blocs such as the NAFTA and the European Community. *See ROK and Japan to Promote Asia-Pacific Economic Cooperation as Response to NAFTA*, *supra* note 13. The NAFTA has spurred renewed interest in the Malaysian-proposed East Asian Economic Group. *See Japan to Issue 'Strong Warning' on NAFTA at APEC*, Japan Economic Newswire, Sept. 7, 1992, *available in* LEXIS, Nexis Library, JEN File. Similarly, some U.S. commentators have called for a regional response to concerns about the EC turning into a "fortress Europe." *See Baucus Calls For Pacific Rim Trade Pact to "Counter" Unified EC*, 7 INSIDE U.S. TRADE, No. 9, Mar. 3, 1989, at 11.

[48] *See generally* BERKELEY ROUNDTABLE ON THE INTERNATIONAL ECONOMY (BRIE), THE HIGHEST STAKES: THE ECONOMY FOUNDATIONS OF THE NEXT SECURITY SYSTEM (1992); GILPIN, *supra* note 40; Krasner, *supra* note 40; PAUL KENNEDY, THE RISE AND FALL OF THE GREAT POWERS (1987).

[49] Many articles have described the difficulties associated with the conclusion of the Uruguay Round. *See, e.g.*, *Negotiators Grapple With Response to Uruguay Round Breakdown*, 10 INSIDE U.S. TRADE, No. 14, Apr. 3, 1992, at 1. As an example of the many articles reflecting bilateral trade tensions between the United States and Japan, see *Trade Officials, Senators, Embrace "Results-Oriented" Japan Policy*, 11 INSIDE U.S. TRADE, No. 11, Mar. 19, 1993, at 6. And for an example of the many articles reflecting heightened bilateral trade tensions between the United States and the European Community, see *Baucus calls for Pacific Rim Trade Pact to "Counter" Unified EC*, *supra* note 47.

indicate increasing regionalism: for example, Japan's commercial and financial ties throughout Asia have grown more extensive in the past twenty years;[50] Asian nations are considering forming their own East Asian Economic Group (EAEG);[51] and the EC's economic ties have been spreading throughout Europe, Africa, and the Middle East with the conclusion of "association" agreements and other preferential arrangements.[52]

C. *Conclusions From the Economic and Political Frameworks for Assessing Regional Trade Blocs*

These frameworks suggest that both an economic and a political perspective would find minimizing trade diversion in regional trade blocs valuable. From an economic perspective, trade diversion is inefficient: It leads to increased production by higher-cost member state producers at the expense of lower-cost producers from outside the region. From a political perspective, trade diversion may contribute to the disintegration of the world trading system into regionalism. Furthermore, trade diversion is at the heart of non-member resentment towards the creation of a free-trade area or customs union.

III. The NAFTA's Trade Diversion from Asia

A. *Principles Favoring Trade Diversion Under the NAFTA*

A brief examination of how the NAFTA will divert trade from Asia will help further define the problem of trade diversion resulting from regional trade blocs.

The NAFTA will contribute to trade diversion in at least five

[50] *See generally* 2 The Political Economy of Japan: The Changing Political Context (Takashi Inoguchi & Danitel I. Okimoto eds., 1988).

[51] *See EAEG Will Not Be Trading Bloc: Mahathir*, Jiji Press Ticker Service, July 22, 1991.

[52] Prior to the collapse of the Warsaw Pact, the EC had established "association" agreements and other preferential arrangements with certain African and Malagasy states (*see* 14S BISD 100 (1966)), Algeria (*see* 24S BISD 80 (1978)), Cyprus (*see* 21S BISD 94 (1975)), Egypt (*see* 21S BISD 102 (1975)), Israel (*see* 18S BISD 158 (1972)), Jordan (*see* 25S BISD 133 (1979)), Lebanon (*see* 22S BISD 43 (1976)), Malta (*see* 19S BISD 90 (1973)), Morocco (*see* 18S BISD 149 (1972)), Syria (*see* 25S BISD 123 (1979)), Tanzania, Uganda, and Kenya (*see* 19S BISD 97 (1973)), Tunisia (*see* 18S BISD 149 (1972)), Turkey (*see* 13S BISD 59 (1965)), Yugoslavia (*see* 28S BISD 115 (1982)), and with the European Free Trade Area (EFTA) countries of Austria (*see* 20S BISD 145 (1974)), Finland (*see* 21S BISD 76 (1975)), Iceland (*see* 20S BISD 158 (1974)), Norway (*see* 21S BISD 83 (1975)), Sweden (*see* 20S BISD 183 (1974)), and Switzerland and Liechtenstein (*see* 20S BISD 196 (1974)). Since the end of the Cold War, the EC has concluded "association" or preferential trade agreements with Poland, Czechoslovakia, Hungary, Bulgaria, and Romania; these recent agreements are as yet unpublished.

ways. The first, tariff liberalization, is the basic cause of trade diversion identified by Viner and others.[53] While tariffs within North America are eliminated, North American tariffs against products imported from Asia will remain unchanged. Therefore, goods produced in another NAFTA country will become relatively less expensive to North American consumers. In short, the tariff wall around North America will remain unchanged, while the tariff wall within North America will fall.

Second, the non-tariff barriers eliminated within North America could result in trade diversion if they continue to apply against goods produced outside the region. Traditionally, the most formidable non-tariff barriers have included quotas, technical standards, customs inspection and valuation rules, and health and safety measures that may be disguised barriers to trade.[54] While existing rules under the General Agreement on Tariffs and Trade (GATT),[55] as well as new rules in the NAFTA, will help discipline the last three potential non-tariff barriers listed above,[56] the elimination of quotas on intra-regional trade is likely to contribute to increased intra-North American trade. With U.S. quotas lifted on many Mexican agricultural products currently subject to quotas, increased U.S. imports from Mexico could displace some U.S. imports of those products from Asian countries, leaving some of their quotas unfilled.

Third, the NAFTA will liberalize ground transportation between Mexico and the United States. The NAFTA would phase in complete cross-border trucking access throughout North America over a period of six years.[57] This development should reduce transportation costs significantly for goods produced in Mexico and shipped to U.S. and Canadian markets. It will make almost all Mexican products marginally more price-competitive

[53] VINER, *supra* note 20, at 43; *see also* MEADE, *supra* note 29; SCITOVSKY, *supra* note 29; Dam, *supra* note 29.

[54] *See supra* notes 32-36 and accompanying text.

[55] For example, the Tokyo Round Agreement on Technical Barriers to Trade will help regulate the use of technical standards that might otherwise act as barriers to trade with countries outside the region. *See* 26S BISD 8 (1980). Similarly, the Tokyo Round Agreement on article VII of the GATT helps discipline against customs valuation abuses. *See* 26S BISD 116 (1980).

[56] The NAFTA provisions on sanitary and phytosanitary measures, while not legally binding on NAFTA members against charges by non-members, will require that such measures be based on scientific evidence. *See* NAFTA, *supra* note 1, art. 712. The simultaneous application of a non-science based standard by a NAFTA member against a non-member is unlikely because it would probably be viewed as discriminatory.

[57] *See* NAFTA, *supra* note 1, Annex 1212. *See also* Reservations for Existing Measures and Liberalization Commitments, Schedule of Mexico, *id.* Annex I.

than they are currently (compared to Asian products) and could therefore contribute to trade diversion.[58]

Fourth, the NAFTA will require a seven-year phase-out of Mexico's duty draw-back program.[59] Under Mexico's current duty draw-back program, Mexico reimburses the duty paid (usually by the importers) on imports of inputs used in the manufacturing of products that are then "re-exported" from Mexico.[60] Given the elimination of U.S. tariffs on Mexican products, a continuation of the duty draw-back program would have yielded a huge advantage to Mexican production over U.S. production. Mexican products would have benefited not only from inexpensive labor and duty-free export to the United States, but also from duty-free importation into Mexico of inputs for those products. Elimination of Mexico's duty draw-back program means that Mexico will impose non-reimbursable tariffs on Asian components for use in finished products bound for the United States or Canada. To the extent that the Mexican tariff on inputs is currently high, and the U.S. tariff on Mexican-produced finished products is reduced or eliminated, the elimination of duty draw-back will favor increased Mexican use of North American inputs to the disadvantage of Asian inputs.

Fifth, the NAFTA rules of origin pertaining to many products have been drafted to favor the use of inputs produced within the free-trade area in the assembly of goods in the area. The primary purpose of the rules of origin is to ensure that the NAFTA benefits are accorded only to goods produced in the North American region—not to goods made wholly or in large part in other countries. The NAFTA's general rule of origin specifies that goods will be considered as originating in North America if they are wholly North American.[61] Goods containing non-regional materials also are considered North American if the non-regional materials are transformed in the NAFTA region so as to undergo a change in Harmonized Tariff System (HTS) tariff classification.[62]

58 Of course it will contribute to trade creation as well by reducing transportation costs for goods produced in other countries within the region.

59 *See* NAFTA, *supra* note 1, art. 303; *id.* Annex 303.7, § B (Mexico).

60 Thus, under current practice, Mexico would reimburse a Mexican automobile manufacturer for duties paid on the importation of Asian automobile parts, if those parts were used in an automobile manufactured in Mexico and exported to the United States.

61 NAFTA, *supra* note 1, art. 401.

62 *Id.*

This, however, is not the only rule of origin: NAFTA contains several hundred "special" rules of origin for particular products.[63] These special rules of origin specify an extraordinary threshold of regional content in order to receive the benefits of the NAFTA. Therefore, if manufacturers of goods subjected to those special rules want to receive the benefits of the NAFTA, they will be required to use an extraordinary type, level, or proportion of regional inputs. These special rules will usually result in displacement of non-regional inputs in the assembly of such products as automobiles and textiles in North America.

B. *Factors Tending to Ameliorate NAFTA Trade Diversion*

At least five sets of factors may ameliorate the trade diversion likely to result from the NAFTA. First, the trade diversion effects of reduced intra-regional tariffs are moderated by the fact that U.S. tariffs on extra-regional goods will remain at relatively low levels.[64] U.S. tariffs vary by product, but their trade-weighted average (excluding oil) in 1989 was only about five percent.[65] This means that the elimination of U.S. tariffs on Mexican products will give those products, on average, only a five percent duty advantage over Asian products. Moreover, many Mexican products already enter the United States duty-free under the U.S. Generalized System of Preferences (GSP).[66] The GSP program is designed to assist some developing countries by offering them duty-free treatment on specified products to promote trade as an alternative to foreign aid. Thus, the NAFTA will not greatly improve Mexico's competitive position by eliminating the duty on those products already receiving special treatment under the GSP program.

Second, manufacturers and consumers of products requiring skilled or semi-skilled labor, particularly high-technology products, may be wary of quality control problems associated with Mexico's unskilled labor force. This concern will most likely in-

[63] *Id.* art. 403 (automotive goods); *id.* Annex 401, § XI (textiles).

[64] Viner identified the average tariff level on extra-regional goods as a factor that would affect the extent of trade diversion. *See* VINER, *supra* note 20, at 51 (second factor).

[65] According to Barbara Norton, Director of Tariff Affairs, Office of the United States Trade Representative (USTR), the USTR's calculations are based on statistics provided to USTR by the Department of Commerce. Telephone Interview with Barbara Norton, Director of Tariff Affairs, Office of the United States Trade Representative (USTR), (January 26, 1993).

[66] *See* Title V of the Trade Act of 1974 (codified as amended at 19 U.S.C. § 2461 (1988 and Supp. III 1992)); General Note 3(c)(iii) of the Harmonized Tariff Schedule.

fluence the decisions of U.S. manufacturers considering a suitable location for their overseas manufacturing facilities. In addition, manufacturers may be apprehensive of corruption and uncertainties in Mexico's regulatory, judicial, and political environments. These concerns may even deter some manufacturers from moving to Mexico.

Third, increased industrial production in Mexico will increase the demand for and price of Mexican labor,[67] and thereby diminish the comparative cost advantage of Mexican labor against some Asian labor.

Fourth, liberalization within the new free-trade area theoretically will result in an aggregate increase in the size of the North American market for all goods, including those coming from outside North America.[68] The theory of comparative advantage predicts that liberalization within a particular region will lead to increased efficiency as a result of trade creation.[69] This, in turn, will increase demand and aggregate regional production.[70] Increased demand by industry and consumers will extend not only to regionally produced goods, but to imports from outside the area as well.[71] Through this scheme, some Asian trade may eventually benefit from the increased North American demand created by the NAFTA.

Fifth, businesses and governments outside North America will act in ways to reduce the NAFTA trade diversion. Because liberalization of sensitive industries will be phased in under the NAFTA over a period of five to fifteen years, many Asian industries will have time to plan and reallocate resources in order to minimize the trade-diversion effects. For example, Asian manufacturers probably will identify products that will be in greater demand in North America as a result of NAFTA trade creation. In particular, these manufacturers should concentrate on products that could serve as inputs into Mexican-assembled final products bound for the U.S. market. This will require paying close attention to the NAFTA rules of origin. It is likely that some Asian components will be price-competitive and that their use will not disqualify Mexican-produced finished products from

67 *See* INTERNATIONAL TRADE COMMISSION, *supra* note 5, at 2-3, 2-6 (projecting increased Mexican average wages as a result of NAFTA).

68 VINER, *supra* note 20, at 44.

69 *Id.*

70 *Id.*

71 This effect of a regional trade agreement on imports from outside the region was identified by Viner. *Id.*

NAFTA treatment.[72] Thus, the extent to which Asian industry is disadvantaged by the NAFTA will depend in part on how Asian businesses respond. Potential government actions to ameliorate the NAFTA's trade diversion will be discussed below in Parts IV and V.

C. *The Impact of the NAFTA's Trade Diversion on Seven Sectors of Asian Industry*

The extent of trade diversion created under the NAFTA will depend on the balance between diversionary and amelioratory effects. That balance must be judged on a product-by-product basis. Asian governments and businesses have expressed particular concern about trade diversion in the textile, automobile, automobile parts, light truck, electronics, toy, and steel sectors. The following sections will analyze the impact of trade diversion on each of these Asian industries.

1. *Textiles*

Textile exports from Asia to the United States will be one of those hardest hit by the NAFTA. Textiles (including apparel) are among the leading exports produced by developing countries in Asia. In 1989, textiles accounted for over thirty percent of all exports from Hong Kong, South Korea, and the People's Republic of China.[73] Approximately one-third of those exported textiles went to North America.[74]

Textile imports into the United States currently are subject to both quotas and tariffs under the Multifiber Arrangement (MFA).[75] This restrictive regime offers strong protection to U.S. textile and apparel manufacturers; the MFA quotas restrict the quantity of imported textiles that can compete with textiles produced in the United States. The NAFTA will eliminate both tar-

[72] For example, while the NAFTA will make the supply of certain Mexican-produced apparel to the United States much more competitive, it offers opportunities to Asian textile producers to supply certain specified types of textiles to Mexico, for use in shaping and sewing apparel. Where technology permits shifting to the production of the specified textiles, such a shift might be advisable. For a discussion of the NAFTA's effects on the textiles and apparel industry, see text accompanying notes 73-85 *infra*.

[73] UNITED NATIONS, 1990 INT'L TRADE STAT. Y.B., vol. I, tbl. 2, at 403, 500, and 170.

[74] Of $47.9 billion of total clothing exports from the developing economies of Asia in 1989, $19.5 billion worth was exported to Canada and the United States. 1990 INT'L TRADE STAT. Y.B., spec. tbl. B, at S-84 and S-85.

[75] Arrangement Regarding International Trade in Textiles, Dec. 20, 1973, 25 U.S.T. 1001, 930 U.N.T.S. 166.

iffs and quotas for "qualifying" goods—goods manufactured in North America that meet the strict NAFTA textile rule of origin.[76]

The determination as to whether a textile will receive the principal benefits of the NAFTA will turn on whether or not it is a "qualifying" good. This will be determined according to a "yarn-forward" rule of origin, which means that most textile and apparel goods must be of North American origin from yarn to end product in order to receive the full benefits of the NAFTA.[77] Further, the United States, Canada, and Mexico will immediately eliminate or phase out over a maximum of ten years their duties on qualifying goods with respect to one another.[78] Tariffs need not be reduced for most products manufactured in North America that are "non-qualifying" goods.

In addition, the United States will immediately remove import quotas on qualifying textiles from Mexico,[79] and will gradually phase out the quotas on non-qualifying Mexican textile and apparel goods[80] that meet the normal U.S. rule of origin—"substantial transformation."[81] The net effect of these rules will be to increase U.S. and Canadian imports of textiles and apparel manufactured in Mexico using North American yarn and fabric. These increased imports from Mexico will occur at the expense of existing imports from Asia and elsewhere, and will also displace sales of some apparel manufactured in the United States. In addition, they will result in an increase in U.S. exports of yarn and fabric to Mexico, while reducing North American imports of yarn and fabric from other countries.

Significant exceptions to the yarn-forward rule exist, and Asian manufacturers can be expected to take advantage of them. For example, some apparel will remain under a single substantial transformation rule of origin and will receive the full benefits of the NAFTA as long as certain provisions are met. These provisions require the apparel to be cut or knit to shape, and sewn or otherwise assembled in a NAFTA member country, and to be made from specified fabrics in short supply in North America (in-

[76] *See* NAFTA, *supra* note 1, Annex 401, § XI; *id.* Annex 300-B, §§ 2, 3.

[77] *See* NAFTA, *supra* note 1, Annex 401, § XI.

[78] *Id.* Annex 300-B, app. 2.1 (Tariff Elimination).

[79] *Id.* Annex 300-B, app. 3.1(B)(10)-(11).

[80] *Id.* Annex 300-B, app. 3.1(B)(9); *see also id.* Annex 300-B, scheds. 3.1.1 and 3.1.2.

[81] After the phase out of import quotas on non-qualifying Mexican textile goods, the U.S. textile industry will be able to protect itself against the import of such goods through duties.

cluding Harris tweed, velveteen, and widewale corduroy).[82] Similarly, brassieres, silk and linen apparel, and men's dress shirts made from certain types of cotton, or cotton and man-made fiber blends, will remain under a single substantial transformation rule of origin and will receive the full benefits of the NAFTA if cut or knit to shape, and sewn or assembled in a NAFTA country.[83]

Another significant exception to the basic rule of origin states that some non-qualifying yarn, fabric, and apparel made in North America is eligible for preferential duty treatment up to agreed-upon annual levels.[84] This favored treatement will be achieved through tariff rate quotas (TRQs). The TRQs will give preferential access to limited quantities of products, including non-qualifying cotton and man-made fiber spun yarn (but not sewing thread); specified types of fabric, made-up products and apparel; specified non-qualifying wool apparel; and some non-qualifying hosiery.[85] It is likely, then, that Asian textile manufacturers might consider producing inputs for these products, assembling the final products in Mexico, and taking advantage of the preferential TRQs. Aside from relatively narrow exceptions like these, the NAFTA's treatment of textiles is likely to reduce Asian exports of textiles to North America.

2. *Automobiles*

The NAFTA should have relatively little practical impact on Asian exports of automobiles to North America.[86] In the case of textiles, import barriers are very high because of restrictive quotas, and NAFTA liberalization gives a great advantage to qualifying textiles manufactured in Mexico. In contrast, U.S. duties on automobiles are not very high, so NAFTA liberalization should not give a substantial relative advantage to Mexican production.

More specifically, the United States will immediately eliminate its tariffs on passenger automobiles manufactured in Mexico.[87] At the same time, Mexico will reduce its tariffs on U.S. and Canadian passenger automobiles by fifty percent, and eliminate the

[82] *See* NAFTA, *supra* note 1, Annex 300-B, §§ 2, 3; *id.* Annex 401, § XI, ch. 62, n.2.

[83] *Id.* Annex 300-B, §§ 2, 3; *Id.* Annex 401, § XI.

[84] *Id.* Annex 300-B, app. 6(B).

[85] NAFTA, Annex 300-B, especially sched. 6.B.1, 6.B.2, and 6.B.3.

[86] In 1990, Japan and South Korea exported nearly $24 billion of passenger motor vehicles (excluding buses) to Canada and the United States. 1990 INT'L TRADE STAT. Y.B., Vol. II, at 1192-93.

[87] *See* NAFTA Tariff Schedules, Schedule of the United States, HTS no. 8703.

remaining tariffs over ten years.[88] Similarly, Canada will reduce and eliminate tariffs on Mexican autos on the same schedule.[89] Because the U.S. tariff on passenger automobiles is currently so low (only 2.5%),[90] its elimination for Mexican automobiles will not have a great effect on the relative competitiveness of Asian automobiles.

The NAFTA rules for application of U.S. Corporate Average Fuel Economy (CAFE) regulations,[91] however, will provide an important benefit for U.S. automobile producers. Those regulations impose a "gas guzzler" tax on automobile fleets with low average fuel efficiency. For purposes of applying CAFE standards, manufacturers are deemed to have two fleets: (1) a domestic fleet, including all cars with at least seventy-five percent domestic (U.S. and Canadian) content, and (2) a foreign fleet, including all cars with less than seventy-five percent domestic (U.S.-Canadian) content.

The NAFTA will calculate CAFE standards differently in three periods.[92] In its first three years, the NAFTA will treat Mexican value-added as foreign content. In years four through ten, the manufacturer may choose whether Mexican value-added is domestic or foreign value. After the tenth year, all Mexican value-added will be considered domestic content. These rules will permit U.S. automobile manufacturers, beginning in the fourth year of the NAFTA, to reduce their potential liability for CAFE assessments. This could be achieved by treating Mexican value-added in Mexican-produced small cars as domestic content, thereby reducing the U.S. automobile manufacturer's CAFE for its domestic fleet. Although this rule will not affect the "gas guzzler" tax that can be assessed on Asian-produced automobiles, it may permit U.S. automobile manufacturers to avoid a CAFE tax that they otherwise might have had to pay, thereby marginally increasing their profits.

3. *Automobile Parts*

Although the NAFTA will not decrease North American sales of Asian automobiles much, it will affect the Asian automobile

88 *Id.*

89 *Id.*

90 *Id.*

91 *See* 40 C.F.R. § 600; 49 C.F.R. § 526; *see also* 15 U.S.C. § 2001 (1988).

92 *See* NAFTA, *supra* note 1, Annex 300-A, app. 300-A.3.

parts industry significantly.[93] The general NAFTA rule of origin for automobiles will require 62.5% regional content in order to qualify for NAFTA benefits.[94] The NAFTA's regional content requirement will replace the rule under the United States-Canada Free Trade Agreement (FTA) which requires fifty percent regional content.[95] Thus, the 62.5% NAFTA rule of origin will provide a strong incentive for North American automobile manufacturers to use North American auto parts. This may adversely affect Asian automobile parts manufacturers.

4. *Light Trucks*

The NAFTA could also have serious adverse effects on Asian exports of light trucks to the United States.[96] The current U.S. truck tariffs of twenty-five percent for most light trucks[97] will be eliminated for Mexican-produced light trucks.[98] To the extent that Asian production has not already moved to the United States, the NAFTA will divert some production from Asia to Mexico in order to avoid the twenty-five percent U.S. tariff on the Asian-produced vehicles.

5. *Electronics and Small Appliances*

The effects of the NAFTA on the competitiveness of Asian electronics exports to the United States will vary from product to product. The impact on individual products will depend primarily on two key factors: the current effective U.S. duty rate on the product,[99] and the comparative cost of producing Asian and Mexican electronic goods in the absence of a duty.

Competition between Asian and Mexican manufacturers of products for which the U.S. duty is relatively low (but not zero),

[93] In 1990, Japan and Korea exported approximately $6.5 billion of motor vehicle parts to Canada and the United States. 1990 INT'L TRADE STAT. Y.B., *supra* note 86, at 1198-99.

[94] *See* NAFTA, *supra* note 1, art. 403(5)(a).

[95] *See* United States-Canada Free-Trade Agreement, Annex 301.2, § XVII, paras. 3-5.

[96] In 1990, Japan and Korea exported approximately $2.3 billion worth of light trucks to Canada and the United States. 1990 INT'L TRADE STAT. Y.B., *supra* note 86, at 1194-95.

[97] *See* NAFTA Tariff Schedule of the United States, *supra* note 87, HTS nos. 8704.21.00, 8704.31.00, 8704.22.00 and 8704.90.00. *See generally* Herman Walker, *Dispute Settlement: The Chicken War*, 58 AM. J. INT'L L. 671 n.34 (1964).

[98] *See* NAFTA Tariff Schedule of the United States, *supra* note 87, HTS nos. 8704.31, 8704.32, and 8702.90, and note 1 to Chapter 87 of the Schedule.

[99] Where the U.S. tariff is high, elimination of the duty on Mexican products will make them increasingly competitive with Asian products.

will be affected by the NAFTA only where production costs are roughly equal. For example, the Korean and Mexican manufacturing costs of some color televisions are almost equal.[100] Thus, assuming rough equivalence of quality between Asian- and Mexican-produced color televisions, elimination of the U.S. five percent duty on Mexican color televisions under the NAFTA probably will displace some U.S. sales of Korean television sets.[101] Some other products, including some radio products,[102] semiconductors, computer parts, and telecommunications equipment also face a U.S. duty of less than five percent. In these cases, elimination of the duty on Mexican products by the NAFTA will adversely affect Asian products only at the margin.

Conversely, where the current U.S. duty is relatively high, the NAFTA will help increase the competitiveness of Mexican products. Some radio products and telecommunications equipment or parts fall into this category, with duty rates of eight to ten percent.[103] For Mexican products which fall under the Generalized System of Preference (GSP) program and are currently duty-free, the NAFTA will not change the competitive position of Asian goods. Currently, Mexican-produced microwave ovens, toaster ovens and toasters, as well as electro-mechanical domestic appliances such as electric can openers, are afforded GSP zero-duty treatment.[104]

6. *Toys*

Some Asian production of toys is likely to suffer trade diversion because of the NAFTA.[105] As in the electronics sector, the extent of trade diversion will vary by toy product, depending on the tariff level currently imposed on the specific type of toy product.

[100] *See* KOREAN MINISTRY OF TRADE AND INDUSTRY, MEASURES TO BE TAKEN (BY KOREAN INDUSTRY) IN RELATION TO NAFTA (Oct. 1992) (on file with the *Stanford Journal of International Law*).

[101] In 1990, the United States and Canada imported approximately $250 million worth of color television receivers from Korea, and approximately $816 million worth from the rest of Asia. 1990 INT'L TRADE STAT. Y.B., *supra* note 86, at 1170-71.

[102] In 1990, the United States and Canada imported approximately $2.1 billion worth of radio products from Asia. *Id.* at 1172-73.

[103] *See* NAFTA Tariff Schedule of the United States, *supra* note 87, HTS nos. 8527.29, 8532.10, 8532.21.

[104] In 1990, the United States and Canada imported approximately $1.1 billion worth of household-type domestic appliances and equipment from Asia. 1990 INT'L TRADE STAT. Y.B., *supra* note 86, at 1186-87.

[105] In 1990, the United States and Canada imported approximately $4.4 billion worth of toys and sporting goods from Asia. *Id.* at 1254-55.

For example, some imported toys (such as dolls not over thirty-three centimeters in height, billiard balls, and doll carriages) currently face tariffs in the 7.5% to 12% range.[106] Tariffs on Mexican-produced toys of that type will be eliminated immediately upon entry into force of the NAFTA, but will continue to be imposed on otherwise identical Asian-produced toys. This may make it more attractive to produce such toys in Mexico.

Most other imported toys and games (such as chess and checkers game sets, video games, electric trains, ice skates, and baseball, football, and tennis articles) currently face U.S. tariffs in the two to seven percent range.[107] Tariffs on these Mexican-produced toys will also be eliminated upon entry into force of the NAFTA. While these tariffs will remain in effect against otherwise identical Asian-produced toys, the trade diversion effects on these products are likely to be less pronounced than on the goods identified in the preceding paragraph, which face a relatively higher tariff.

Finally, some toys produced in Mexico (such as chain-driven wheeled toys, stuffed dolls representing human beings, and some stuffed or filled toys representing animals or non-human creatures) already enter the United States duty-free under the U.S. GSP program,[108] so the NAFTA will not result in any trade diversion of those products.

7. *Steel*

The NAFTA is expected to have only a minor impact on Asian steel production.[109] North American tariffs on regionally-produced steel will be phased out over a period of ten years, but those tariffs are already relatively low. Most iron and steel tariffs are in the one to five percent range, although some steel products (particularly specialty ones) face tariffs as high as 11.6%.[110] Since the NAFTA automobile rules of origin require 62.5% North American content, North American production may dis-

[106] *See* NAFTA Tariff Schedule of the United States, HTS nos. 9501.00.60, 9502.10.40, and 9504.20.20.

[107] *See* NAFTA Tariff Schedule of the United States, HTS nos. 9503.80.80, 9504.10.00, 9504.90.60, and 9506.99.05-.20.

[108] *See* NAFTA Tariff Schedule of the United States, HTS nos. 9502.10.20, 9503.41.10, and 9501.00.20.

[109] In 1989, the United States and Canada imported approximately $4.7 billion worth of iron and steel from Asia. 1990 INT'L TRADE STAT. Y.B., *supra* note 73, spec. tbl. B, at S-72 and S-73.

[110] NAFTA Tariff Schedule of the United States, *supra* note 87, Chapter 72; *cf.* HTS nos. 7226.91.25 and 7228.10.00 with HTS nos. 7203.10-7402.50.

place some Asian production of steel used in automobiles. However, the major issue facing Asian steel producers will not concern the NAFTA, but rather the outcome of on-going antidumping and countervailing duty cases, and the possibilities of global settlement. Scores of such cases have been filed since negotiations over a Multilateral Steel Agreement broke down last year.[111]

IV. International Legal Solutions to the Problem of Trade Diversion

As discussed above, the NAFTA is likely to produce substantial trade diversion, especially in the textile, automobile parts, light truck, electronics, and toy industries. This diversion may be traced to two sets of causes. The first set comprises "natural" causes which will necessarily be associated with the establishment of any free-trade area or customs union—namely, the elimination of intra-regional trade barriers combined with the maintenance of barriers to trade from countries outside the region. The second set of causes is the establishment of "special" preferential rules of origin. This section will analyze current GATT treatment of these two causes of trade diversion and propose alternative legal solutions for minimizing potential trade diversion resulting from the NAFTA.

This section will illustrate that the GATT's current treatment of customs unions and free-trade areas offers little meaningful relief to concerns about trade diversion. It will argue that proposals to revise or reinterpret the GATT to prohibit the establishment of customs unions or free-trade areas that do not represent a move towards free trade are economically impracticable and politically infeasible. Furthermore, this section will advance the idea that the best antidote to the trade diversion effects of regionalism may be the negotiation of multilateral tariff and non-tariff barrier reductions. Finally, this section will propose the adoption of a new international rule to eliminate discriminatory preferential rules of origin.

111 *See generally AISI Warns Against Political Deal on Steel Crisis, Insists on Finishing Cases*, 11 Inside U.S. Trade, No. 9, Mar. 5, 1993, at 13-14. *See EC Calls for Antidumping Consultations on Steel Cases After MSA Talks Stall*, 11 Inside U.S. Trade, No. 10, Mar. 12, 1993, at 17-18.

A. *Current GATT Treatment of Free Trade Areas and Trade Diversion*

It has been suggested that Asian governments should consider challenging the NAFTA's rules of origin in the GATT.[112] A challenge to the NAFTA and its rules of origin could be mounted either by attempting to obtain a decision from the Contracting Parties to block the formation of the North American free-trade area (pursuant to GATT article XXIV:7),[113] or by bringing the parties to the NAFTA to GATT dispute settlement procedures (pursuant to GATT article XXIII).[114] As explained below, neither challenge is likely to succeed: Both approaches risk raising the ire of U.S. policy-makers and provoking stronger attacks on allegedly unfair Asian trading practices.

1. *General GATT Principles*

Article I of the GATT—the Most Favored Nation (MFN) principle—is the Agreement's cornerstone. It ensures that:

> With respect to customs duties and charges of any kind . . . and with respect to all rules and formalities in connection with importation and exportation . . . any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.[115]

If no other provisions existed, this central tenet of non-discrimination would prevent the establishment of free-trade areas and customs unions.

However, despite the importance of GATT article I and the necessarily discriminatory aspects of a free-trade area, the GATT permits (and indeed may be read to encourage) the establishment of free-trade areas.

Article XXIV:5 states (subject to provisos analyzed below) that "the provisions of this agreement shall not prevent, as between the territories of contracting parties, the formation of a

[112] *See Japan and Others Concerned Over NAFTA Pact at GATT*, Reuters, Sept. 30, 1992, *available in* LEXIS, Nexis Library, Reuters File; *see also Japanese Warn NAFTA Could Become Protectionist "Burden" to Asia*, Agence France Presse, Nov. 24, 1992, *available in* LEXIS, Nexis Library, AFP File.

[113] GATT, *supra* note 24, art. XXIV, para. 7.

[114] GATT, *supra* note 24, art. XXIII. *See generally* Julia Christine Bliss, *GATT Dispute Settlement Reform in the Uruguay Round: Problems and Prospects*, 23 STAN. J. INT'L L. 31 (1987).

[115] GATT, *supra* note 24, art. I.

customs union or of a free-trade area."[116] This approach is reflected in article XXIV:4, which states, in relevant part: "The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements."[117] This "recognition" may be rooted in the fact that opinions about free-trade areas were almost uniformly positive when the GATT was negotiated.[118]

This is not to suggest that the GATT's drafters were blind to the potential for abuse of the right to create free-trade areas. Article XXIV:4 stipulates that the purpose of creating a free-trade area "should" not be "to raise barriers to the trade of other contracting parties with such territories."[119] Use of the word "should" indicates that article XXIV:4 alone would provide a relatively weak basis for attacking or defending a free-trade area that had alleged disguised barriers to trade with territories from outside the area. Other parts of article XXIV, some of which are analyzed below, provide explicit substantive rules to flesh out the general principle. There is no consensus, though, on how to relate the more explicit substantive rules to the general principle.

From the perspective of the European Community, these substantive rules "must be interpreted interdependently" with the general principles of article XXIV:4.[120] Other nations argue that article XXIV:4 "establishes the basic principle" which the GATT should apply to ensure that agreements creating customs unions and free-trade areas are "consistent with the objectives of GATT," and that it should serve as a basis for resolving questions about the application of the more specific article XXIV rules.[121] Nonetheless, under either view, the general principles of article XXIV should inform interpretations of the more specific rules defining the acceptable "regulations of commerce" included in a free-trade area agreement.

116 *Id.* art. XXIV, para. 5.

117 *Id.* art. XXIV, para. 4.

118 VINER, *supra* note 20, at 41.

119 GATT, *supra* note 24, art. XXIV, para. 4.

120 *European Economic Community: Reports adopted on 29 November 1957 (L/778)*, 6S BISD 70 (1958).

121 This is the position of "most members" of the Sub-Group examining the Treaty of Rome. *Id.* at 71, para. 3.

2. *A Contracting Party's Challenge to the NAFTA Rules of Origin*

Procedurally, the drafters of the GATT provided only a narrow right to block the establishment of a free-trade area. Article XXIV:7 permits the Contracting Parties to review proposed free-trade areas prior to their implementation, and to block the entering into force or the maintenance of the free-trade area only if they find that the agreement is "not likely to result in the formation of a customs union or of a free-trade area within the period contemplated by the parties to the agreement or that such period is not a reasonable one."[122]

Article XXIV:8(b) states that a "free-trade area" shall be understood to mean a "group of two or more customs territories in which the duties and other restrictive regulations of commerce . . . are eliminated on substantially all the trade between the constituent territories in products originating in such territories."[123] Consequently, if a party could show that free-trade area rules of origin would not permit the "duties and other restrictive regulations of commerce" to be effectively "eliminated on substantially all the trade between the constituent territories," then the Contracting Parties would be within their rights to block formation of that free-trade area, unless the parties to the area modified their agreement in accordance with the recommendations of the Contracting Parties.

Some of the NAFTA's rules of origin are drawn so narrowly that they may be viewed as not eliminating duties on products from one of the North American territories. For example, the textiles rule of origin generally would not permit a piece of apparel cut and sewn in Mexico to enter the United States duty-free unless it were made of North American yarn.[124] Similarly, as described above, the rules of origin on automobiles are drafted very narrowly.[125]

Nonetheless, article XXIV:8 requires that nations eliminate duties and other restrictive regulations of commerce on "substantially all the trade between the constituent territories."[126] While "substantially all the trade" has never been defined in the GATT,[127] it clearly implies "less than all trade."[128] Thus, the

122 GATT, *supra* note 24, art. XXIV, para. 7.
123 *Id.* art. XXIV, para. 8(b).
124 *See supra* text accompanying note 77.
125 *Id.*
126 GATT, *supra* note 24, art. XXIV, para. 8.
127 Various GATT Working Party reports on agreement presented under article

rule does not require liberalization with respect to every product. Since the GATT Contracting Parties have consistently approved European Free Trade Area (EFTA) agreements with third countries that expressly exclude all agricultural products from free-trade area liberalization,[129] it is extremely unlikely that the Contracting Parties would decide that the NAFTA rules of origin prevent the liberalization of "substantially all the trade" among NAFTA members.

Moreover, the procedures of article XXIV:7 are unlikely to be read broadly so as to give the Contracting Parties broad discretion over the approval of a free-trade area. The general understanding by those drafting the GATT was that:

> [T]here was no question of the [Contracting Parties] . . . having any power to approve or disapprove a customs union . . . . If the [Contracting Parties] find that the proposals made by the country . . . will in fact lead towards a customs union in some reasonable period of time . . . they must approve it. They have no power to object.[130]

It seems reasonable to apply this interpretation of article XXIV:7 to the Contracting Parties' authority to pass judgment on the formation of a free-trade area.

3. *A GATT Dispute Settlement Challenge*

The GATT dispute settlement mechanism is an alternative means of challenging free-trade area rules of origin that allegedly "raise barriers to the trade of other contracting parties with such territories."[131] Parties challenging the NAFTA's rules of origin in dispute settlement could raise two arguments. First, they

XXIV record statements that the meaning of "substantially all the trade" has never been defined in GATT. *See, e.g.*, 18S BISD 164 (1972), 21S BISD 80 (1975), and 27S BISD 132 (1981).

128 Report of the Working Party on Agreement Between the EFTA Countries and Spain, 27S BISD 127, 132 (1981).

129 *See, e.g.*, Report of the Working Party on the Examination of the Stockholm [EFTA] Convention, adopted 4 June 1960, 9S BISD 70 (1961); *see also* Report of the Working Party on the Agreement Between the EFTA Countries and Spain, *supra* note 128.

130 Discussions at the Tariff Agreement Committee, Proces-Verbaux, Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment (Geneva, Apr.-Oct. 1947). GATT Doc. EPCT/TAC/PV/11.

131 The quoted language is a principle embodied in GATT, article XXIV, para. 4. *See supra* note 24. GATT dispute settlement (pursuant to article XXIII) can be used to challenge non-compliance with a GATT provision resulting from "any measure." *See* Report of the Panel, *E.C.-Tariff Treatment on Imports of Citrus Products From Certain Countries in the Mediterranean Region*, GATT Doc. L/5776, para. 4.18 (1985) [hereinafter *E.C. Citrus Panel Report*].

could argue that the rules violate the explicit proscription of article XXIV:5(b).[132] This provision specifically states that with respect to a free-trade area,

> the duties and other regulations of commerce maintained in each of the constituent territories and applicable . . . to the trade of contracting parties not included in such area . . . shall not be higher or more restrictive than the corresponding duties and other regulations . . . existing in the same constituent territories prior to the formation of the free-trade area.[133]

A second argument might be that the rules of origin are causing "non-violation" nullification or impairment under article XXIII:1(b) of the GATT.[134] Both arguments, however, face serious hurdles.

Asian contracting parties could contend that some of the NAFTA rules of origin, such as those applying to automobiles and textiles, are inconsistent with those provisions. The argument based on article XXIV:5(b) suffers from some serious weaknesses. The above-quoted language appears to require only that the regulations of commerce for each constituent member state in the free-trade area not be more restrictive than that member state's regulations before formation of the free-trade area. In other words, the language is directed at the regulations (e.g., rules of origin) of "each of the constituent territories," not at the regulations of the free trade area as a unit.

This reading of the plain language of subparagraph 5(b) is reinforced by the GATT provision that while a "customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories,"[135] to which GATT

[132] Technically, such an argument would be based also on GATT art. XXIII, para. 1(a), *see supra* note 24, which permits a contracting party to prevail at GATT dispute settlement if: (1) "any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or . . . the attainment of any objective of the Agreement is being impeded" and (2) the other contracting party is failing to "carry out its obligations under this Agreement." Failure to carry out obligations under the General Agreement creates a prima facie case of nullification or impairment. *See* Report of the Panel, *Japan—Custom Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, 34S BISD 83, at para. 5.16 (1988).

[133] GATT, *supra* note 24, art. XXIV, para. 5(b).

[134] In contrast to an article XXIII, para. 1(a) dispute settlement challenge, an article XXIII, para. 1(b) challenge requires showing that "nullification or impairment" results from "the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement." GATT, *supra* note 24, art. XXIII, para. 1(a)-(b).

[135] *Id.* art. XXIV, para. 8(a).

obligations apply directly (according to article XXIV:1),[136] a "free-trade area" remains a "group of two or more customs territories."[137] As a result, the article XXIV:5(b) rule would not apply to the free-trade area as an entity. Each constituent member of the free-trade area would be subject autonomously to GATT rules as to trade restrictions toward non-area territories.[138]

In order to raise a successful article XXIV:5(b) challenge, Asian nations would have to argue that the NAFTA is making each member state's rules of origin "more restrictive" with respect to products from non-member states which were transformed in one of the NAFTA member states. In addition, the Asian nations must contend that products imported into the United States after undergoing sufficient transformation in Mexico are not to be treated as Mexican, but rather as coming from outside the free-trade area. Because the U.S. GATT obligation under article I previously required offering "Mexican" products a duty rate no higher than the U.S. MFN duty rate, however, non-member countries would find it difficult to complain that the new NAFTA rule of origin is "more restrictive" than the previous "corresponding" regulation. Indeed, goods now deemed as non-regional will continue to receive MFN duty treatment.[139]

Asian nations would face further legal difficulties if they attempt an alternate argument under GATT article XXIII:1(b), that the NAFTA rules of origin cause "non-violation" nullification and impairment of GATT benefits.[140] Parties challenging the rules of origin could argue that they had no reasonable expectation that preferential regional rules of origin might be established when they negotiated the concessions now adversely affected by those rules.[141]

136 *Id.* art. XXIV, para. 8(b).

137 *Id.*

138 *See* John H. Jackson, World Trade and the Law of GATT 584 (1969).

139 One possible exception could be where U.S. importation turns on a quota, as in the case of textiles. The new NAFTA rule of origin could possibly be seen as "more restrictive" than the previous "corresponding" rule with respect to goods that were previously treated as being of Mexican origin (and subject to Mexico's quota) and now are treated as being of third country origin (and subject to the third country's quota). However, imposition of a quota suggests that the product is covered by a GATT exception or understanding independent of the NAFTA, because otherwise, the quota would violate the provisions of GATT art. XI. Thus, for example, textiles are covered by a *sui generis* GATT-approved regime, and the extent to which textiles quotas are subject to the rules of article XXIV is questionable at best.

140 GATT, *supra* note 24, art. XXIII, para. 1(b).

141 In the U.S.-EC Dispute on Citrus Fruits, a GATT Panel established that a finding of "non-violation" nullification or impairment requires showing that the complaining

This argument, however, has four defects. First, insofar as the GATT permits the establishment of regional trade arrangements and the imposition of "preferential" origin rules in the context of those arrangements, it would be difficult to contend that the parties had "no reasonable expectation" when they negotiated the concessions that the "preferential" rules of origin might be imposed.

Second, the adversely affected non-member goods are being displaced by production in a third country that is not imposing the allegedly "nullifying and impairing" measure. For instance, the United States may apply a NAFTA rule of origin to displace non-member goods with regional goods, but such displacement (and associated "nullification and impairment") would occur not in the United States—the country accused of "nullifying or impairing" the tariff concession—but in Mexico. No GATT precedent for finding "nullification and impairment" by such indirect means exists.

Third, the North American countries could argue that "non-violation" nullification and impairment requires a showing that the overall balance of rights and obligations derived from GATT rules has been disturbed by the adoption of the measures in question.[142] Applying that interpretation, the North American countries could argue that the NAFTA does not adversely affect the balance of GATT benefits accruing to Asia, because the NAFTA eventually will result in larger North American markets for Asian products. These enlarged markets will adequately balance the trade diversion resulting from the region's rules of origin.

Finally, even if a dispute settlement panel finds "non-violation" nullification or impairment under article XXIII:1(b), the remedy available might not satisfy Asia. A dispute settlement panel finding a GATT violation could require the violating parties to withdraw the offending measure. In contrast, however, a finding of "non-violation" nullification or impairment cannot re-

party had no reasonable expectation that the nullifying or impairing measure would be imposed when it negotiated the adversely affected concessions. *See E.C. Citrus Panel Report, supra* note 131, para. 4.26; *see also* Report of the Working Party on the Australian Subsidy on Ammonium Sulphate, 2 BISD 188, 192-93, at para. 12 (1950); Report adopted by Contracting Parties, *Treatment by Germany of Imports of Sardines*, 1S BISD 53, at 58, paras. 16-17 (1953).

[142] This is a well-accepted view that has substantial support in the GATT preparatory work. *See, e.g.*, E/PC/T/A/PV/6 of June 2, 1947 at 5; *see also EC Citrus Panel Report, supra* note 141, para. 4.37; JACKSON, *supra* note 138, at 181.

quire the withdrawal of illegal measures (since there are none); rather it encourages the payment of compensation by means of tariff reductions to the benefit of nations harmed by the measures.[143] And such compensation need not be made by reducing tariffs on the products for which concessions were nullified or impaired.

4. *Conclusions About Current GATT Treatment of Free Trade Areas and Their Rules of Origin*

The GATT does not offer much assistance to Asian nations concerned that the NAFTA and its rules of origin will result in reduced trans-Pacific trade. When the drafters of the GATT incorporated an approval of free-trade areas, they were most likely unaware of the problem of trade diversion and they probably never contemplated the use of free-trade area rules of origin as artificial barriers to trade. As a result, the explicit proscriptions of article XXIV do not address the specific problem at hand.

Nonetheless, neither the problem of trade diversion nor its exacerbation by regional rules of origin are new to the GATT. Countries outside of Europe often have expressed concern that "strict rules of origin" in EFTA agreements and past EEC agreements with Mediterranean countries would limit the scope of free trade in a manner inconsistent with the requirements of article XXIV:8(b), and would raise barriers to the trade of third countries contrary to the obligations of article XXIV:5.[144] The EC and EFTA countries have responded that rules of origin are necessary in a free-trade agreement in order to prevent deflection of trade, not to limit the scope of free trade nor to create obstacles to third country exports.[145] Moreover, they argue that while the GATT provides for rules of origin, it does not define any criteria

[143] It is well established that article XXIII does not require a contracting party to suspend or withdraw a nullifying or impairing measure not in conflict with the GATT. Havana Reports (formal summaries of negotiation of the Havana Charter, *see supra* note 22) at 155. However, in cases of "non-violation" nullification or impairment, the Contracting Parties may authorize an affected contracting party to suspend the application of appropriate obligations or concessions under GATT. Report of the Working Party on the Australian Subsidy on Ammonium Sulphate, *supra* note 141, para. 16.

[144] *See, e.g.*, Working Party Report on Agreement Between the EFTA Countries and Spain, Nov. 10, 1980, 27S BISD 127, 135, at para. 27 (1981). The compatibility of rules of origin with article XXV is also discussed in various other Working Party reports. *See, e.g.*, 24S BISD 73, 78, 86, 95, 104 (Agreement with Portugal, July 26, 1977); 21 BISD 76, 82, 90, 98, 106 (Agreement with Finland, Oct. 21, 1974); 20S BISD 145, 152, 165, 177, 190, 203 (Agreement with Austria, Oct. 19, 1973).

[145] *See, e.g.*, Working Party Report on the Agreement Between the EFTA Countries and Spain, *supra* note 144, para. 28.

with regard to these rules.[146] These issues have never been resolved, and neither a GATT dispute settlement panel nor the Contracting Parties have ever found trade diversion to be a suitable basis for attacking free-trade agreements. Neither has it been held that the GATT proscribes narrow rules of origin in a free-trade agreement.

Therefore, parties desiring to minimize the "natural" causes of trade diversion, as well as trade diversion resulting from a region's "special" rules of origin, may have to search for solutions beyond the current text of the GATT.

B. *Antidotes to "Natural" Causes of Trade Diversion: An Agreement on Multilateral Market Access*

In 1963, Kenneth Dam, one of America's leading scholars on the GATT, suggested the possibility of a "creative" reinterpretation or revision of article XXIV. Specifically, he recommended a revision or reinterpretation that would consider "whether a proposed customs union or free-trade area is a movement toward or away from free trade."[147] Such an analysis would involve determining whether the positive production and consumption effects of the regional arrangement outweigh the negative production and consumption effects associated with trade diversion. A creative reinterpretation would be based on the article XXIV:4 statement of general principle that "the purpose of a customs union or free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties."[148]

Dam's proposal suffers from four drawbacks. First, for reasons explained above, applying the trade diversion/trade creation model to determine whether a particular free-trade area or customs union is a net benefit to the world economy is nearly impossible.[149] Regional liberalization in new sectors (e.g., transportation and services sectors) and new issues (e.g., intellectual property, sanitary and phytosanitary regulation and harmonization) make such a determination even more difficult. These problems suggest that applying a legal standard for evaluating regional and economic arrangements that turns on an estimation

[146] *See, e.g.*, Working Party Report on the Agreement Between the EEC and Lebanon, May 17, 1978, 25S BISD 142, 149, para. 25 (1979).

[147] Dam, *supra* note 29, at 663.

[148] *Id.*

[149] *See supra* text accompanying notes 26-37.

of its trade-creation and trade-diversion effects would be difficult.[150]

Second, the strictly economic criteria of the proposal ignore the adverse political effects associated with trade diversion from a free-trade area or customs union. Use of political criteria might suggest the appropriateness of an outright prohibition on the establishment of regional trade blocs on the ground that the establishment of free-trade areas encourages the dissolution of the multilateral system into competitive and protective trade blocs, treating them as essentially preferential arrangements that contradict the principles of MFN and multilateralism.

Third, it is highly unlikely that the GATT Contracting Parties would agree to such rules at this time. Both of the leading economic powers among GATT signatories, the United States and Europe, have already formed regional trade arrangements, and thus are expected to be unwilling to subject those arrangements to rules that could result in their abolition. It is simply too late to adopt such a rule.

Fourth, a "creative" reinterpretation of an international agreement (such as article XXIV) is not always advisable for an international judicial body (such as a GATT dispute settlement panel), which is vulnerable to de-legitimation when it legislates obligations that nations did not intend to undertake when they negotiated the underlying instrument. Such "creativity" risks irreparably damaging the reputation and legitimacy of an international quasi-judicial body, thereby reducing the probability that decisions of the body will be followed.[151] In the GATT context, further evaluation of such concerns would be prudent before embracing a "creative" reinterpretation.

In light of this analysis, it may be appropriate to search for an alternative solution to the problem of "natural" trade diversion. "Natural" trade diversion resulting from regional market access liberalization may be neutralized by negotiating non-members' market access to the free-trade area on terms equivalent to those of the members.

The simplest way to do this might be for non-members to accede to the free-trade agreement. Indeed, the NAFTA contains

150 *See supra* text accompanying notes 29-31.

151 For a discussion of actions that may legitimize or de-legitimize domestic courts in precarious political circumstances, see SAMUEL HUNTINGTON, POLITICAL ORDER IN CHANGING SOCIETIES 25-26 (1968).

an accession provision.[152] However, in the short term, it is unlikely that the parties to the NAFTA would be inclined to negotiate the accession of an Asian country: at this time, the governments of Canada and the United States are finding it challenging enough to gain legislative approval of just the current three-party agreement. Thus, the Clinton Administration has chosen not to seek congressional authority to negotiate accession to the NAFTA of any other country under expedited, fast-track procedures.[153] A request for such authority may be made after the NAFTA is implemented, but, in that case, accession would focus on other countries in the Americas—not Asia.[154] Even in the long run, the accession of certain Asian parties would be problematic. For example, Japanese accession is highly unlikely as long as it poses significant competition to U.S. and Canadian industries and allegedly maintains structural barriers to trade that are not addressed by the NAFTA.[155]

A more successful approach in both the short run and the long run might be for non-members to negotiate multilateral market access concessions with members of the regional trading group. By pulling down the tariff walls between the region and the rest of the world, non-members will enjoy the same access to the region's territory as members.

For instance, Asian governments may individually or jointly request that the United States reduce its tariffs on those electronics products whose export from Asia to the United States would otherwise be displaced. In exchange, Asian governments would reduce tariffs on some products upon request by the United States, or make other concessions to open their markets to U.S. products.[156]

[152] NAFTA, *supra* note 1, art. 2204.

[153] *Administration Opts not to Pursue Fast Track for Bilateral Pacts at this Time*, 11 INSIDE U.S. TRADE, No. 15, Apr. 16, 1993, at 1.

[154] *Kantor Sees Free Trade Deal with Chile Immediately After NAFTA Implementation*, 11 INSIDE U.S. TRADE, No. 17, Apr. 30, 1993, at 15.

[155] Moreover, accession of Asian and other American countries to the NAFTA would result in a bi-regional international trade system (a U.S.-centric NAFTA and the EC), which raises many of the same concerns as a tri-regional structure.

[156] Asian countries adversely affected by the NAFTA rules of origin are not entitled to unilateral U.S. tariff reductions pursuant to article XXIV, para. 6. Article XXIV, para. 6 provides for unilateral "compensatory adjustment" if, in the course of creating a free-trade area, a "contracting party proposes to increase any rate of duty inconsistently with the provisions" of its article II schedule of bound tariff concessions. GATT, *supra* note 24, art. XXIV, para. 6. The NAFTA rules of origin do not expressly or effectively increase the rate of duty on Asian products imported into the territory of Canada, Mexico, or the United States.

The Uruguay Round market access negotiations offer Asia its best opportunity at this time for negotiating access. Uruguay Round negotiators are in the process of concluding the market access negotiations. Projected effects of the NAFTA in the absence of multilateral tariff reductions should help Asian governments determine for which products it should seek greater access. For example, the NAFTA may make the U.S. "zero for zero" proposal (for reciprocal duty-free treatment) more attractive in the electronics sector than it was in the past: elimination of the U.S. duty on electronics products on an MFN basis would put Asian products on an equal footing with Mexican products which will enjoy zero-tariff treatment under the NAFTA.

Even in the absence of a multilateral tariff round (e.g., after the Uruguay Round market access negotiations are concluded), non-regional contracting parties could still attempt to enter into individual ad hoc supplementary tariff negotiations with separate members of the NAFTA bloc. Such negotiations could take place under the authority of the GATT "Procedures for Negotiations Between Two or More Contracting Parties."[157] These procedures are employed regularly by GATT contracting parties who wish to engage in tariff negotiations outside GATT negotiating rounds. The procedures require that notification of intent to negotiate be given to the Contracting Parties, and suggests the use of a model protocol, which has been established under the procedures and provides for incorporation of the results into the GATT.[158] Of course, the GATT article I MFN provision would require that the benefits of resulting tariff concessions be extended to all contracting parties.

While this "solution" does not promise to eliminate the problem of trade diversion resulting from regional arrangements, it offers a practical solution for reducing the disruptive effects of trade diversion. Moreover, this solution is feasible: unlike an attack on the NAFTA (which is unlikely to succeed and would probably provoke a negative response from U.S. policy-makers), the United States government has long supported the negotiation of mutual tariff reductions on a reciprocal basis.

[157] Procedures for Negotiations Between Two or More Contracting Parties, 1 BISD 116 (1952).

[158] *Id.* § 1.

C. *An Antidote to the Rule of Origin Problem: Adoption of a GATT Agreement or Understanding on Rules of Origin*

Recognizing that the GATT currently does not proscribe trade diverting rules of origin, one may consider whether it is feasible to attempt to negotiate a GATT agreement or understanding that would address allegedly discriminatory preferential rules of origin in the NAFTA and the EC. U.S. policy-makers would probably view such an approach more favorably than recourse to dispute settlement procedures: it would not only attack EC rules of origin practices that the United States has considered unfair, but would also be seen as a constructive effort to bolster the multilateral trading system and to combat regionalism.

The Uruguay Round is the most obvious forum for such a negotiation.[159] These negotiations have produced a Draft Agreement on Rules of Origin,[160] which establishes a transition period after which all "non-preferential" rules of origin must be based on "where the last substantial transformation was carried out," as determined by a criterion of "change in tariff classification"[161] instead of value-added or other criteria that may be used to create a disguised barrier to trade. However, this requirement does not extend to "preferential" rules of origin (i.e., rules of origin adopted for application to a free-trade area, customs union, or common market).[162] The draft agreement's only "disciplines" on "preferential" rules of origin are found in Annex II, which contains largely hortatory rules and imposes no meaningful restrictions on "preferential" rules of origin.[163] In negotiations over the draft agreement prior to 1992, the United States demanded that the "change in tariff classification" rule apply to "preferential" as well as "non-preferential" rules of origin, because it wanted to eliminate the allegedly discriminatory rules of

[159] While political agreement on the general terms of the Uruguay Round package could be concluded as early as Summer of 1993, completion of the Uruguay Round and its details would still be a complex process that may stretch out over another four to six months. Indeed, translating political agreement on the general text into an accurate legal document acceptable to all parties is a complicated task.

[160] Draft Agreement on Rules of Origin, Dec. 20, 1991, GATT Doc. MTN.TNC/W/FA, at D.1-14 [hereinafter Draft Agreement].

[161] *Id.* arts. 3(b) and 9:2(c)(ii), respectively. Supplementary criteria could be used only "where the exclusive use of the HS nomenclature does not allow for the expression of substantial transformation." *Id.* art. 9:2(c)(iii).

[162] Application of this rule to "preferential" rules of origin is precluded by the definition of "rule of origin" in article 1 of the Draft Agreement. *Id.* art. 1(2).

[163] *Id.* Annex II.

origin promulgated by the EC.[164] The EC refused to comply with the United States' demand, and since decisions in the group negotiating the document require consensus, the resulting draft agreement would not apply to "preferential" rules.

Asian nations could attempt to reopen this issue. Since the United States has now adopted "special" preferential rules of origin in the NAFTA, it might now agree with the EC position and resist extension of this discipline to "preferential" rules of origin. However, the United States has been on record in the Uruguay Round negotiations as a strong advocate of extending meaningful disciplines on "preferential" rules of origin, such as the "change in tariff classification" standard. Moreover, such an extension would serve as a basis for attacking the EC's allegedly discriminatory rules.

The United States should thus consider foregoing the "special" rules of origin in the NAFTA, in exchange for disciplines curbing rules of origin abuses of the GATT article XXIV right to establish free-trade areas and customs unions.[165] In the long run, the United States and those championing an open international trading system will benefit from such a discipline, because it would reduce the trade diversion effects of regional arrangements and the associated contributions of such effects to the dissolution of the multilateral system into trade blocs.

If reaching an agreement on such a discipline in the context of the Uruguay Round is not possible, two alternative GATT fora for the adoption of such a rule exist. First, pursuant to GATT article XXV, the Contracting Parties, by joint action, may accept an understanding that includes such a rule. Article XXV:1 states, in relevant part, that "Representatives of the contracting parties shall meet from time to time for the purpose of giving effect to those provisions of this Agreement which involve joint action and, generally, with a view to facilitating the operation and furthering the objectives of this Agreement."[166] Joint action is usu-

[164] Author's observations of periodic negotiations in Geneva, Switzerland, in 1989 and 1990, and Brussels, Belgium (Dec. 1990).

[165] A possible compromise between the United States and the EC would be to grandfather all existing NAFTA and EC rules of origin, and apply meaningful disciplines from this time forward. Such a compromise would not address trade diversion resulting from the NAFTA's current rules of origin, but it would ensure that North American countries and the EC do not modify rules of origin in an undisciplined manner in the future.

[166] GATT, *supra* note 24, art. XXV:1.

ally taken in the context of a monthly GATT Council meeting or at the annual Contracting Parties' Session.

Second, the Uruguay Round Draft Agreement on Rules of Origin would establish a Committee on Rules of Origin to, *inter alia*, "carry out such other responsibilities assigned to it under [the Agreement] or by the Contracting Parties."[167] The GATT Council could therefore assign to the Committee the responsibility of negotiating more substantial disciplines on preferential rules of origin. The results of that negotiation would then be reported back to the GATT Council, which could approve the negotiated disciplines pursuant to its authority under article XXV.

V. CONCLUSION: A SUGGESTED APPROACH TO AMELIORATING TRADE DIVERSION

As a general rule, the formation of a customs union or free-trade area will inevitably lead to some trade diversion. Such trade diversion is economically inefficient, resulting in increased levels of high-cost production within the region at the expense of lower-cost production from outside the region. Moreover, trade diversion is politically costly, engendering resentment by nations outside the region and contributing to a process of decay of the international system into regional blocs.

The NAFTA is of course no exception: it too will result in trade diversion. The NAFTA will cause trade diversion not only by "natural" means (i.e., intra-regional tariff reduction without corresponding reductions of the same tariffs vis-à-vis non-members), but also through the adoption of "special" rules of origin for many products. These rules will require Mexican production to employ an extraordinary level, type, or proportion of regional inputs in order to enjoy the benefits of the NAFTA. A variety of Asian products—such as textiles, automobile parts, light trucks, some toy and electronic products bound for North America—will be particularly disadvantaged. The GATT currently does not provide a solution to these problems. Article XXIV permits, and may even be read to encourage, the formation of free-trade areas and customs unions.[168] Furthermore, the GATT does not disci-

[167] Draft Agreement, *supra* note 160, art. 4(1). This provision also authorizes the Committee to "consult on matters relating to . . . the furtherance of the objectives set out in [Parts I-IV of the Agreement]," but those Parts do not address preferential rules of origin.

[168] GATT, *supra* note 24, art. XXIV.

pline discriminatory preferential rules of origin.

In this context, adoption of a new international rule on preferential rules of origin would be appropriate. Such a rule would deem "change in tariff classification" as the touchstone of preferential origin determinations. In addition, non-members of regional trade arrangements whose trade is diverted because of those arrangements would be advised to seek access to the North American market on terms equivalent to those afforded to members. While the simplest way to achieve such access might be by accession to the NAFTA, accession of Asian members does not appear feasible in the short term, and accession of some countries seems unlikely even in the long term. In that light, non-members may be advised to seek a multilateral reduction of tariff and non-tariff barriers to minimize the "natural" trade-diversion effects of customs unions and free-trade areas. It is perhaps ironic that the rules which permit the establishment of customs unions and free-trade areas, resulting in associated trade diversion and adverse political effects, also thereby shift the incentives of countries outside the region towards pursuing a multilateral reduction of tariff and non-tariff barriers.

In order to ameliorate the effects of the NAFTA, Asian governments should focus on rules and measures that further the principle of multilateralism. They should pursue a quick conclusion and implementation of the Uruguay Round of trade negotiations, including provisions in the market access agreement and the Agreement on Rules of Origin to maximize free trade with North America.[169] If necessary, after the Round is concluded, Asian governments can still pursue increased market access and disciplines on preferential rules of origin that may be disguised barriers to trade. In both the short and the long run, Asian governments' best weapon against regionalism and its trade-diversion effects will likely be a vigorous pursuit of multilateralism.

169 In the short run, the Uruguay Round offers the best vehicle for ameliorating the trade diversion resulting from the NAFTA. It is a convenient forum for improving Asian access to the U.S. market in areas where the NAFTA would otherwise give Mexico and Canada advantageous access. Moreover, it could lead to the adoption of a discipline against preferential rules of origin that are disguised barriers to trade. And most importantly, in light of the NAFTA, the Uruguay Round's liberalization of textiles may represent the last and best hope for Asian manufacturers of some textiles and apparel hoping to maintain their share of the U.S. market.