NAFTA: a review of the issues

Linda M. Aguilar

Because the United States is Mexico's largest trading partner and Mexico is the United States' third largest trading partner, Mexico's economic ups and downs are felt by many U.S. industries. The five largest U.S. exports to Mexico in 1991 were electrical machinery, nonelectrical machinery, transportation equipment, chemicals, and primary metals; totaling slightly less than two-thirds of manufacturing exports to Mexico that year. And the interdependence between the two countries is growing. In 1971, the U.S. provided 61.4 percent of Mexico's imports and received 61.6 percent of its exports. By 1989, those numbers had grown to 70.4 and 70.0, respectively. As illustrated in Figure 1, U.S. exports to Mexico rise and fall with the Mexican economy. During the 1970s, growth in U.S. exports was closely aligned to Mexican gross domestic product (GDP)—that is, changes in Mexican GDP were met by roughly an equal change in U.S. exports. But by the 1980s, the relationship had changed. As Mexico's economy expanded or contracted, U.S. exports increased or decreased by a greater amount. For example, in 1986, Mexican GDP declined 25.4 percent; U.S. exports declined 45.4 percent.

It seems plausible to conclude that U.S. policies that stimulate growth in Mexico could quickly benefit the U.S. One such policy is the proposed free trade agreement between the United States, Mexico, and Canada known as the North American Free Trade Agreement or NAFTA (see Box 1 for an overview of NAFTA). The potential benefits of a regional trading bloc to these nations are enormous. In 1990, the combined GDP of the three countries was $6.2 trillion, a full $221.3 billion greater than the European Economic Community's. Thus, all three countries would benefit from reduced costs, more competitive prices, and greater global trading power.

This article examines the trade relationship between the U.S. and Mexico[1] over the last few years, and discusses the potential benefits to the U.S. and the Seventh District of NAFTA. It also explores three of the issues negotiators faced during their eighteen months of negotiations that are of particular concern to the Seventh District: U.S. jobs and worker retraining, rules of origin, and the environment (that is, water and air quality).

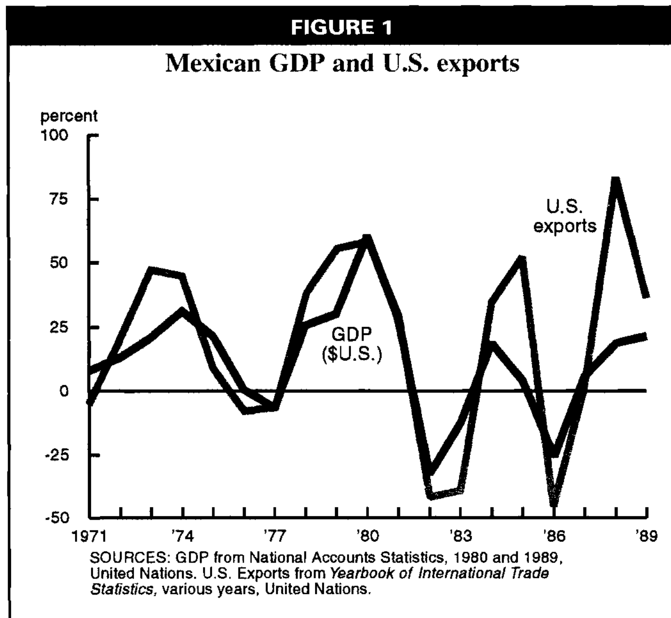
Trade initiatives in Mexico

During the early 1970s, Mexico's economic and trade policies were considered protectionist. Foreign investment was restricted and many industries were state owned. Imports consisted primarily of industrial supplies, capital equipment, industrial and nonauto transportation equipment, and transportation parts. Exports were primarily agricultural and manufactured goods. Manufactured goods were derived largely from the "maquiladora" plants: foreign owned (mainly U.S.) plants that bring unfinished parts and components into Mexico

Linda M. Aguilar is a regional economist at the Federal Reserve Bank of Chicago. The author would like to thank William Testa, Carolyn McMullen, and Kathryn Moran for their helpful comments and insights.

FIGURE 1

Mexican GDP and U.S. exports



SOURCES: GDP from National Accounts Statistics, 1980 and 1989, United Nations. U.S. Exports from *Yearbook of International Trade Statistics*, various years, United Nations.

for final processing and assembly prior to reexport into the United States (see Box 2 for an overview of the maquiladora program).

The rise in world oil prices during the 1970s prompted Mexico to develop its huge oil reserves. These reserves, in turn, served as collateral for substantial loans from the rest of the world, and in particular, U.S. banks. Exports of petroleum and petroleum products soared, reaching 75.3 percent of general exports in 1982. But by the early 1980s, world oil prices had topped out, and Mexico could no longer service its debt. New loans to Mexico ceased. Prodded by economic decline, the Mexican government implemented bold economic reforms which stabilized the economy, reignited economic development, and opened new horizons for trade and investment. In 1986, Mexico joined the General Agreement on Tariffs and Trade (GATT) and reduced its tariffs from levels of 100 percent, in some cases, to a maximum of 20 percent, which was even lower than the GATT maximum allowable tariff of 50 percent.[2] In addition, Mexico opened up foreign investment in many sectors and privatized many of its former, state-controlled industries. By the end of the 1980s, Mexico realized it would be necessary to solidify its new position as a growing and prosperous economy by integrating itself more closely, in particular through trade, with its two northern neighbors, the U.S. and Canada.

Impact on the Seventh District

Although the benefits of NAFTA to the U.S. at the regional level are difficult to determine, the Seventh District, which encompasses most of the states of Illinois, Indiana, Michigan, and Wisconsin and all of Iowa, should realize benefits through increased exports to Mexico.

Of particular significance to the U.S. and the Seventh District has been the growth of U.S. manufacturing exports to Mexico. As a region, the five District states increased their manufacturing exports to Mexico 90 percent over the 1987-1991 period; U.S. manufacturing exports increased 130 percent over the same period. Also, roughly half of all manufacturing exports to Mexico over this period were in machinery and transportation equipment, two capital goods producing industries that form the cornerstone of the U.S. and, in particular, the Midwest economies (see Box 3 for recent trends in manufacturing exports to Mexico for the District).

In 1991, exports to Mexico of these two capital goods comprised 68 percent of Seventh District manufacturing exports and 53 percent of U.S. manufacturing exports. The importance of these goods to a growing economy is significant. In order to grow, a developing country needs to build factories, housing, and schools. To support this growth, there must be an infrastructure consisting of roads, airports, sewers, etc. For Mexico, imports of machines and transportation equipment[3] have comprised anywhere from 30 to 55 percent of total commodities imports over the last 20 years. It would be safe to assume that this trend is likely to continue, particularly in the short run, with or without NAFTA. As Mexico develops, the demand for goods produced in the Seventh District, namely machinery and transportation equipment, and the benefits to the District, will also grow.

Labor issues

Among those voicing the strongest reservations about free trade with Mexico are U.S. factory workers, mainly because they fear that U.S. companies, seeking lower labor costs, will

transfer factory operations to Mexico where average compensation costs are far less than their U.S. counterparts (See Table 1). While studies have shown that wages are not necessarily the driving factor in location decisions, it must be recognized that they represent a large share of manufacturing costs. For example, wages of production workers, excluding white

BOX 1

An overview of NAFTA and the trade agreement process

In February 1991, the United States, Mexico, and Canada agreed to begin negotiating a free trade agreement, at the request of Mexico's President Salinas. An agreement among the three countries is expected to benefit all, although at possibly very different levels, and eventually allow each trading partner roughly equal access to the others' markets. Formal negotiations began in June 1991, and on August 12, 1992, it was announced that an agreement had been reached.

Benefits of free trade

The direct benefit of free trade derives from the nearly complete elimination of tariffs between free trade partners. It is expected the U.S. will benefit[1] through expanded trade with a large and growing market, increased competitiveness in world markets, and more investment opportunities for U.S. firms. Mexico will benefit from more open and secure access to its largest market, the U.S.; increased confidence on the part of foreign firms to invest in Mexico; a more stable economic environment; and the return of Mexican owned capital. Canada's benefits are mostly in the form of safeguards: maintaining its status in international trade; no loss of its current trade preferences in the U.S. market; and equal access to Mexico's market. While NAFTA will, on net, benefit each nation, it is not a win-win situation for everybody. It produces both winners and losers among industries and occupations; and it must deal with such issues as worker displacement and rules of origin, as well as address issues such as the impact of free trade on the environment (that is, air and water quality).

The U.S. trade agreement process

Under the directive of the Trade Act of 1974, once the U.S. has decided to enter free trade negotiations with a country(s), the President submits a formal request to Congress requesting authority to negotiate with the proposed trade partner(s). Under the act's "fast track" authority, Congress has 60 legislative days to approve or reject the request. During this period, congressional committee hearings are held to solicit comments and testimony from interested parties. If the request to negotiate an agreement is approved, the negotiations can begin but must be completed within 2 years. Once the negotiators prepare a final agreement, it is submitted to Congress for approval and it must be accepted or rejected as is. That is, no amendments or revisions are allowed. If approved by Congress, the President then signs the agreement and the terms and timetables agreed to by the trading partners can be implemented.

The NAFTA agenda

In agreeing to participate in a free trade agreement, the U.S., Canada, and Mexico developed an agenda of specific trade policies on which the three countries were to agree. The three countries also agreed to address issues and concerns that each country may have about the others' current and future trading policies. Towards that end, working groups were formed to negotiate the following issues:

- Market access
  - Tariffs and nontariff barriers
  - Rules of origin
  - Government procurement
- Trade rules
  - Safeguards
  - Subsidies; countervailing and antidumping duties
  - Health and safety standards
- Services
- Investment
- Intellectual property
- Dispute settlement

Negotiation results

When the agreement was announced on August 12, the following details, by industry, were provided:

Autos—Mexican tariffs were reduced from 20 to 10 percent immediately on autos and on most auto parts within 5 years; NAFTA completely eliminates auto tariffs in 10 years; eliminates export quotas and performance requirements on foreign owned manufacturing facilities in Mexico; eliminates duties on three-fourths of U.S. parts exports within 5 years; and eliminates Mexican import restrictions on buses and trucks within 5 years. To qualify for duty free trade, autos must contain 62.5 percent North American content.

Textiles and apparel—NAFTA eliminates barriers to trade on over 20 percent of U.S. textile and

collar jobs, accounted for 20.5 percent of value added by U.S. manufacturers in 1990.

In addition, U.S. workers' fears are not entirely unfounded. U.S. companies with foreign affiliates in Mexico increased employment from 1977 to 1989 by 146,000 workers (or 39.4 percent) at the same time that employment in foreign operations of U.S. companies worldwide declined by 8 percent (see Table 2). In particular, employment has grown rapidly in electronics industries and in transportation with each of the Big 3 automakers having auto or truck assembly operations in Mexico. These two industries accounted for 47 percent of employment of U.S. operations in Mexico in 1989.

While these figures document the job flight to Mexico, it is important to note that other forces are also dislocating American workers, including the movement of production to other low wage countries, such as Taiwan and Singapore, by both domestic and foreign companies. Thus, U.S. jobs lost to Mexico might instead have been moved to another low wage country rather than remaining in the U.S. In fact, some business and labor representatives believe that open borders with Mexico have, so far, helped preserve jobs in the U.S. that would have otherwise been lost overseas. It is argued that, in some instances, access to low wage labor in Mexico has sustained the U.S. share of such production in the face of foreign competition, and may be the advantage U.S. companies need to remain price competitive in world markets. Some supporters of NAFTA[4] even argue that protecting jobs in industries in which the U.S. does not hold a comparative advantage makes both the U.S. and Mexico less prosperous. U.S. jobs "saved" in one industry are merely jobs lost in other industries.

From a U.S. perspective, Mexico's growing economy, together with NAFTA, may have a positive effect on the U.S. economy. A recent Commerce Department report indicates that in 1990, exports to Mexico supported 538,000 domestic jobs and that for every 10 jobs directly supported (for example, manufacturing jobs), another 19 more jobs (such as supplier jobs) are indirectly supported.[5] Also, most studies of the impact of NAFTA on U.S. industries agree that industries with increased export potential will be winners (including chemicals, plastics, machinery, and metals) and other industries, especially those that have been tariff protected (such as citrus crops, sugar, apparel, and furniture) will be losers. However, on net, the U.S. will likely realize only small or negligible increases in production.

apparel exports; eliminates barriers on another 65 percent over the next six years; and provides strong rules of origin in order to qualify for duty free status.

Agriculture—one-half of U.S. exports to Mexico will be duty free immediately, with remaining goods to be tariff free within 15 years.

Energy and petrochemicals—NAFTA allows private ownership and operation of electric generating plants for self-generation, cogeneration, and independent power plants; provides immediate access to trade and investment for most petrochemicals; and allows U.S. firms to negotiate directly with Mexican purchasers of natural gas and electricity and to conclude contracts with PEMEX, Mexico's state run petroleum company, or CFE, Mexico's state owned electricity firm.

Electronics and telecommunications—NAFTA eliminates most Mexican tariffs on telecommunications equipment, computers and parts, and electronic components immediately with complete elimination within 5 years.

Financial services—U.S. banks and securities firms will be allowed to establish wholly owned subsidiaries with transitional restrictions to be phased out by January 2000.

Insurance—existing joint ventures will be allowed 100 percent ownership by 1996; new entrants can obtain majority ownership by 1998; and all equity and market share restrictions will be eliminated by 2000.

Investment—Mexico will eliminate export performance requirements and domestic content rules for U.S. firms operating in Mexico.

Land transportation—U.S. trucking firms will be allowed to carry international cargo to the contiguous Mexican states by 1995 with cross border access to all of Mexico by the end of 1999.

Environment—U.S. environmental, health, and safety standards will be maintained, with states and local governments having the ability to increase standards as needed; NAFTA preserves international treaty obligations such as trade limits on protected species and permits more stringent standards to be imposed on new investment.

[1]Benefits to each of the three trading partners are credited to Hufbauer and Schott (1992).

TABLE 1

Hourly manufacturing compensation costs for production workers

	1985	1986	1987	1988	1989	1990	1991
	(--------------------U.S. dollar costs--------------------)						
U.S.	$13.01	$13.25	$13.52	$13.91	$14.31	$14.88	$15.45
Canada	$10.80	$11.00	$11.94	$13.51	$14.81	$16.02	$17.31
Mexico	$1.60	$1.10	$1.06	$1.32	$1.59	$1.80	$2.17

	1985-1988	1989	1990	1991
	(-----Annual % change in U.S. dollar costs------)			
U.S.	2.3	2.9	4.0	3.8
Canada	7.7	9.6	8.2	8.1
Mexico	–6.2	20.5	13.2	20.6

SOURCE: U.S. Dept. of Labor, Bureau of Labor Statistics, *International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing,* 1991 – Report 825.

Worker retraining and other assistance

Although NAFTA will be phased in slowly over many years, it is likely to accelerate the labor market upheaval that certain industries and local areas have already experienced. Particular regions, including the Midwest, are highly concentrated in industries, such as the domestic auto industry, that have and are undergoing deep disruptions.

Officially the Big 3 automakers support "a well crafted NAFTA" and expect that increased trade with Mexico "could result in expanded export opportunities for U.S. vehicle and parts manufacturers."[6] Underlying this statement is

BOX 2

An overview of the maquiladora program

The maquiladora program was initiated in 1965 by the Mexican government in response to the cancellation by the United States of a prior work program, called the bracero program, that allowed Mexican workers to cross the border for seasonal work. The maquiladora program allows 100 percent foreign ownership of a firm located in Mexico for the purpose of manufacture and assembly of products for export. In the original program, imports used in processing were not subject to Mexican tariffs providing they were 100 percent reexported. Recent changes to the program allow a portion of the goods to be sold in the domestic market. Only the value added in Mexico (that is, labor costs and domestic parts) are subject to import tariffs upon reentry. Also, machinery or other items used in the production are exempt from Mexican import tariffs.

The textile industry was the first industry to use the maquiladora program but over time, other labor-intensive industries such as electrical components, furniture, and transportation equipment also opened factories in Mexico. Originally, maquiladoras had to be located along the Mexican border, but that restriction is no longer in force. By 1990, 470,000 workers, including both production and administrative workers, were employed in maquiladoras.

Most maquiladoras are U.S. owned, but there are a few Canadian, Japanese, and European operations as well. Due to the present state of the U.S. economy, more applications to build maquiladoras were received from non-U.S. companies in 1991 than from U.S. companies.

While NAFTA will eventually remove most tariff and nontariff barriers to trade between the U.S. and Mexico, the fate of the maquiladoras is uncertain. The theory that more U.S. plants will relocate to Mexico to take advantage of lower Mexican wages is not necessarily sound. For one, as the Mexican economy grows, the wage gap will eventually decrease. Also, other factors, such as infrastructure and natural resources, play a large part in location decisions. On the other hand, Mexico is a large and growing market, and the decision to relocate to be closer to a firm's market will become a factor in favor of either relocating or expanding operations.

TABLE 2

Employment of U.S. nonbank foreign affiliates

Year	Mexico	Canada	All countries	Non-Mexico	Asia/Pacific
	(------------------	------------------	Thousands of workers	------------------	------------------)
1977	370.1	1,064.5	7,196.7	6,826.6	1,208.3
1982	470.3	913.8	6,640.2	6,169.9	1,159.7
1983	442.9	900.6	6,383.1	5,940.2	1,170.0
1984	430.0	897.9	6,417.5	5,987.5	1,182.0
1985	465.9	900.6	6,419.3	5,953.4	1,155.5
1986	441.9	905.1	6,250.2	5,808.3	1,210.8
1987	438.1	907.8	6,296.6	5,858.5	1,214.7
1988	460.1	965.5	6,403.5	5,943.4	1,283.9
1989	515.8	945.4	6,621.4	6,105.6	1,416.2
Change 1977-89	145.7	–119.1	–575.3	–721.0	207.9
% change 1977-89	39.4	–11.2	–8.0	–10.6	17.2

SOURCE: Department of Commerce, Bureau of Economic Analysis.

the expectation that the potential of the Mexican market is so large that American operations will expand significantly to accommodate it.

Even so, U.S. labor lobbied hard to have worker displacement addressed and job retraining included in NAFTA negotiations. While the Bush administration does recognize that job replacement is likely to occur and recognizes the need for job retraining, no formal program was included in the proposed NAFTA. However, shortly after the NAFTA agreement was completed, President Bush proposed a five year, $3 billion per year job training initiative, of which $2 billion per year would be earmarked for dislocated workers. This plan, called the New Century Workforce proposal, would replace the current Economic Dislocation and Worker Adjustment Assistance program, as well as the Trade Adjustment Assistance Act, and would require congressional approval.

Rules of origin

"Rules of origin" is a trade term which defines the minimum percentage of a country's exported product that must be produced or substantially transformed within the border of the exporting country (also known as "local content"). The term "substantially transformed" means that products that use foreign inputs must go through considerable change (for example, a raw material being processed into a finished good) in order to be used in an export to a free trade partner. The reason for this rule is to limit a country involved in a free trade agreement from using cheaper, foreign parts in its exports and then using its favorable tariff arrangements to avoid higher import tariffs.

While all industries are concerned with this issue, the domestic auto industry, headquartered in the Seventh District, had proposed that a strong rule of origin apply to the automotive industry. In addition to a lengthy phase-in period designed to protect companies with existing operations in Mexico, the Big 3 automakers had suggested that the rules of origin be more stringent in an agreement with Mexico. In the U.S.-Canada free trade act, auto related rules of origin are applied to each plant, with a current minimum of 50 percent local content required. For the U.S.-Canada-Mexico agreement, the Big 3 had suggested that each company, rather than each plant, be allowed to average the local content requirement, with GM suggesting a 60 percent requirement, and Ford and Chrysler proposing 70 percent.[7] NAFTA proposes a 62.5 percent local content rule for passenger vehicles and 60 percent for other vehicles and auto parts based on net cost (total cost less royalties, sales promotion, and packing and shipping).

BOX 3

Seventh District manufacturing exports to Mexico

Over the 1987-1991 period, total export shipments from District states grew from $35.5 billion to $52.9 billion. Exports to Mexico grew by $1.5 billion over this period, or from 4.8 percent of total manufacturing exports to 6.2 percent.

The five largest industries by shipment value to Mexico from District states in 1991 were transportation, machinery except electrical, electrical machinery, primary metals, and fabricated metals. These five industries increased exports to Mexico by $848 million over the period, comprising 55 percent of total manufacturing export growth.

District exports to Mexico grew in other industries as well. For example, in 1987, exports of textiles and apparel to Mexico comprised only 1.7 percent of total textiles and apparel exports. By 1991, exports to Mexico had grown to 18.3 percent of total textiles and apparel exports. Likewise, wood and furniture exports grew from 1.3 percent to 6.1 percent; rubber exports from 3.5 percent to 9.0 percent; fabricated metals from 1.2 percent to 5.7 percent; and primary metals from 6.6 percent to 9.7 percent. Measuring instruments and miscellaneous manufacturing was the only industry that experienced a decline in exports to Mexico over the period.

Recent trends in District manufacturing exports
(Millions of dollars)

Sector	1987	% of District industrtial exports[1]	1991	% of District industrial exports[1]
Food and tobacco	$43.3	3.6	$117.1	6.0
Textiles and apparel	2.1	1.7	44.9	18.3
Wood and furniture	4.0	1.3	51.7	6.1
Publications and printing	18.7	2.6	51.3	4.0
Chemicals	75.7	2.6	147.8	3.3
Petroleum refining	3.5	1.4	2.5	1.7
Rubber	18.9	3.5	110.6	9.0
Leather	0.7	0.7	2.7	1.7
Stone and glass	14.5	3.0	24.5	4.7
Primary metals	50.3	6.6	206.2	9.7
Fabricated metals	25.9	1.2	169.8	5.7
Machinery, except electric	353.0	4.5	933.2	7.9
Electrical machinery	121.4	4.1	273.5	5.4
Transportation	860.8	6.1	1,004.7	6.0
Measuring instruments, miscellaneous manufacturing	123.0	9.7	111.1	3.6
TOTAL	**$1,715.6**	**4.8**	**$3,251.7**	**6.2**

[1]The amounts in this column represent the percent of total District exports of each industry that are exported to Mexico. For example, in 1987, District exports of food and tobacco to Mexico represented 3.6 percent of total District exports of food and tobacco to all foreign countries.

Environmental issues

A third issue addressed by NAFTA was the environmental impact of increased production. Environmental concerns usually were voiced by three interest groups: environmentalists, industry sectors concerned about losing their jobs to low cost Mexican labor, and industry sectors that stand to gain from increased trade with Mexico.

Environmentalists fear that increased trade with Mexico will expand already problematic environmental conditions, such as air and water pollution, and increase health and safety concerns for workers caused by lax (or nonexistent) enforcement of health and safety standards. These concerns are not only for the Mexican workers, but also for the spillover effects in many U.S. cities along the U.S.-Mexico border. For example, those concerned by this issue cite the Mexican maquiladora program that brought thousands of Mexican workers and their families to Mexican border towns without adequate infrastructure to house and feed them. This resulted in substandard living conditions in the Mexican towns and in pollution of the ground water and air of both the Mexican towns and the American towns just north of the border.

Industries concerned about losing their jobs to Mexican workers have embraced the environmentalists' cause and are suspicious that U.S. and foreign companies will relocate to Mexico to avoid their own countries' antipollution laws. The environmentalists also fear the U.S. may relax its own laws to remain competitive.

Industries that stand to gain from NAFTA point to the recent progress Mexico has made towards cleaning up its environment. For example, the Mexican government has lowered the lead content of petrol, closed some of its worst factories, and passed new environmental laws modeled after U.S. laws. In addition, one study of the environmental impacts of NAFTA suggests that because of Mexico's abundance of labor, it is likely that the types of industries that will open or relocate to Mexico will be more labor intensive than capital intensive, resulting in less energy use and less hazardous waste.[8]

Environmental concerns prompted the United States to develop an action plan that directed the Environmental Protection Agency to meet with their Mexican counterparts to ensure that comprehensive environmental, safety, and health standards and enforcement measures were included in the agreement. In the Bush administration's 1993 budget proposal, $241 million is requested for border cleanup, nearly double that of fiscal year 1992. However, in a recently submitted environmental plan, no new cleanup funds beyond 1993 have been requested.[9] Other U.S. agencies, like the Food and Drug Administration, the Department of Agriculture, and the Department of Labor, also were directed to participate in the negotiations to ensure that all U.S. environmental concerns were addressed. The proposed NAFTA includes a section on the environment that stresses no reduction in current standards and a move towards harmonization of standards among the three trade partners. This agreement is the first trade agreement to specifically address the environment.

Conclusion

The potential for the U.S., Canada, and Mexico to become the world's largest regional trading bloc will enhance all three countries' ability to prosper and compete. Mexico will most likely benefit the most from its new standing as a North American trading partner. Its recent moves towards international market liberalization and economic reform have already begun to change the world's view of Mexico in terms of trade and investment; NAFTA will solidify it. The U.S. will benefit not only in terms of increased exports, but also from better and more open relations with Mexico in areas such as drug enforcement and illegal immigration.

However, widespread U.S. support for NAFTA will depend on how well the negotiators were able to protect the wide array of U.S. interests, particularly as they relate to rules of origin, worker retraining and dislocation programs, and the environment. If it is to receive broad based support, the costs and benefits of NAFTA must accrue to those directly affected, rather than unfairly burden or protect the few.

FOOTNOTES

[1]Because the United States and Canada already have an existing free trade agreement, this article will focus on U.S.-Mexico trade relations.

[2]*The likely impact on the United States of a free trade act with Mexico,* United States International Trade Commission, pp. 1-2.

[3]Because of the use of different data sources, the term "capital goods" as it relates to exports from the U.S. and imports to Mexico is not totally comparable.

[4]McTeer (1991), p. 6.

[5]Davis (1992), p. 2.

[6]Chrysler, Ford, and General Motors (1991).

[7]Chrysler, Ford, and General Motors (1991).

[8]Grossman and Krueger (1991).

[9]Stokes (1992), p. 507.

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