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Has Trade Liberalization in Egypt Gone Far Enough or Too Far?

Policy Viewpoint reflects the views of ECES on key policy issues in Egypt. Its content and recommendations are endorsed by the Center's Board of Directors.

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In a bold move in 2004, the Egyptian government reduced the simple and weighted average tariff rates on imports to 12.1 percent and 8.0 percent, respectively. The move was the latest in a series of trade reforms that began in 1991 involving the elimination of quantitative restrictions, phased reduction and rationalization of tariffs, and the removal of anomalies. Trade liberalization could improve resource allocation in favor of activities where Egypt enjoys comparative advantage, reduce the anti-export bias, and improve the fortune of the factor of production most abundant in Egypt (i.e., labor). It could also make cheaper and better products available to consumers, even if some firms have to adjust to increased competition and government has to incur some loss of revenue in the short run.

After 15 years of trade liberalization, has this effort changed the incentive structure facing different economic activities in Egypt to make it as uniform as possible thereby reducing resource misallocation? Has it eliminated the bias against exports and enhanced the country's capacity to earn foreign exchange? More broadly, has it made the Egyptian economy as open to world markets as other emerging markets? These are the questions addressed in this edition of *Policy Viewpoint*.

The upshot of the analysis is that cumulative trade liberalization has reduced the level and dispersion of tariffs, but effective rates of protection for different industries remain far from even. Together with increased exchange rate flexibility since January 2003, this effort has reduced the bias against exports. However, it is important to maintain exchange rate competitiveness in the context of a monetary policy that targets inflation. Finally, although the Egyptian economy is now more integrated globally than before, it could benefit from fine-tuning of the tariff structure, further improvement in trade-related institutions, and greater effort to reduce the cost of doing business to enable firms to compete successfully.

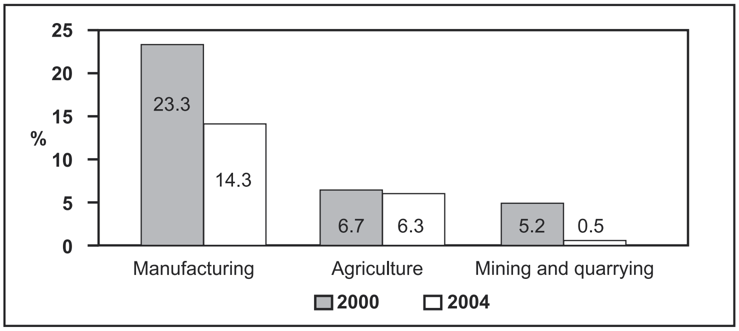
The remainder of this *Policy Viewpoint* first explores the implications of the recent trade liberalization on effective rates of protection of different economic activities. It then assesses its impact on the bias against exports and compares the trade regime in Egypt with that of other emerging markets. To conclude, it offers some policy implications.

Trade Liberalization and Effective Rates of Protection

The 2004 tariff reform is probably the most significant liberalization measure since 1991. It is a unilateral initiative that surpasses Egypt's multilateral commitments under the World Trade Organization (WTO). It was adopted in September 2004, and further modified in December of the same year. The reform package included large tariff reductions, narrowing down of the number of tariff bands from 27 to 6, and the abolishment of the 3-4 percent surcharges on imports. As a result, the average nominal tariff rate (excluding beverages and tobacco) came down from 21.3 percent in 2000 to 12.1 percent in 2004. Tariff dispersion, measured by standard deviation, also declined from 16.1 in 2000 to 12.7 in 2004. Average weighted tariffs followed a similar trend, decreasing from 13.9 percent in 2000 to 8.0 percent in 2004.

What is less obvious, but arguably more important from the perspective of resource allocation, is the impact of trade liberalization on the level and structure of effective rates of protection (ERPs). ERPs capture the net effect of tariffs on outputs and inputs. Figure 1 compares the 2004 estimates for manufacturing, agriculture and mining with Refaat's estimates for 2000 (Refaat 2003). The estimates for 2004 are based on the input-output tables for 1998/99. The comparison clearly indicates that all three sectors now face a much lower level of effective protection than before, with the manufacturing sector continuing to receive the highest level of protection in the Egyptian economy.

Figure 1. Effective Protection in Egypt, 2000 and 2004



Source: Authors' calculation and Refaat (2003).

To gain further insight into the pattern of protection accorded to different industries within the manufacturing sector, ERPs were calculated and the results are reported in Table 1. These results indicate that the level of ERPs declined for all industries except the leather and leather products industry. However, the protection pattern is far from even.

Table 1. Nominal and Effective Protection in Manufacturing in Egypt, 2000 and 2004 (percent)

Manufacturing sectors	Nominal		Effective	
	2000	2004	2000	2004
Food	10.4	7.8	15.4	9.3
Textiles	24.0	9.2	27.6	10.3
Clothes & footwear	38.3	26.7	43.4	31.6
Wood & products	12.9	7.3	12.4	6.9
Paper & printing	15.6	10.2	15.0	9.7
Leather & products	30.0	29.5	34.4	36.1
Rubber	29.1	13.6	32.7	14.9
Chemical	10.6	4.8	8.9	3.2
Non-metallic	23.1	14.7	26.2	16.7
Basic metals	12.5	5.9	11.0	3.7
Machinery & equipment	14.3	8.7	14.1	8.8
Transport	33.6	18.1	38.3	20.4
Simple average	21.2	13.0	23.3	14.3
Standard deviation	9.8	8.0	11.9	10.5

Source: Authors' calculation.

At one extreme, the chemical and basic metals industries receive less than 4 percent protection. At the other extreme, the transport, and clothes and footwear industries receive effective protection rates of 20.4 and 31.6, respectively. At issue is whether this pattern of protection is consistent with Egypt's static or dynamic comparative advantage.

Overall, trade liberalization has increased the exposure of the Egyptian economy to international competition, which will benefit consumers and pressure firms to be more efficient. But these benefits will only materialize with additional reforms to reduce transaction costs, improve contract enforcement and enhance policy predictability. In the industries where the current level of protection is relatively high (e.g., in the automobile, and clothes and footwear industries), survival will require sector-specific restructuring strategies.

Trade Liberalization and the Anti-Export Bias

Tariffs and non-tariff barriers make it more profitable for domestic producers to sell their products at home rather than abroad. The bias against exports is magnified when the exchange rate is overvalued and the cost of exporting is high (e.g., because of poor and expensive infrastructure or excessive administrative requirements). The question addressed in this section is how much the recent trade liberalization and other reforms have diminished the bias against exports.

To answer this question, we employ the methodology used by Galal and Fawzy (2001) to estimate hypothetical rates of return on equity (ROE) and assets (ROA) of two identical Egyptian producers. Both are engaged in manufacturing and operate inland. The first produces fully for overseas markets; the second produces fully for the domestic market. The two producers have the same output, cost structure and balance sheet. They only differ in the way the incentive structure impacts them. The exporter generates revenue in the international market at world prices, and is assumed to benefit from the duty drawback scheme and any export subsidies. By comparison, the producer for the local market is able to charge the international price (c.i.f.) plus tariffs. The producer's ability to charge consumers higher prices depends on the price elasticity of local demand. The less elastic the demand, the greater the ability to charge higher prices, and vice versa.

The results of applying the above methodology are reported in Table 2. These results indicate that the bias against exports has diminished significantly over time. Under the incentive structure of 2000, the producer for the domestic market makes a higher ROE and ROA than the producer for the external market under all assumptions regarding demand elasticity. The difference in profitability diminishes when consumers are assumed to be responsive to changes in prices (elasticity is larger than one), but even then, the producer for the domestic market makes twice the profit made by the exporter. These results help explain why Egyptian exports were modest in the early 2000s.

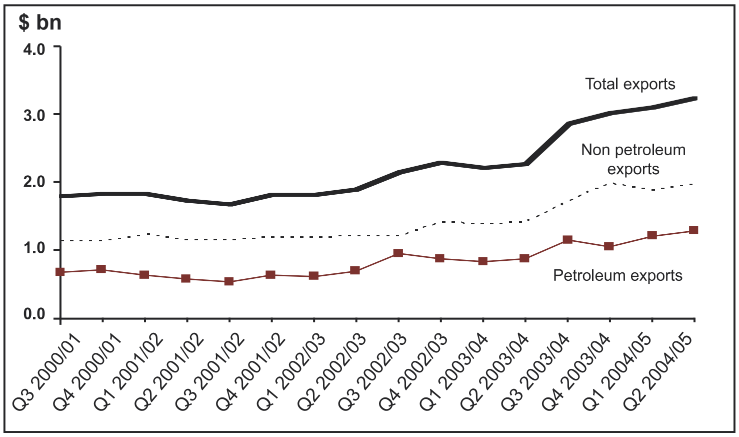
Table 2. Return on Equity and Assets of Two Identical Producers Under the Incentive Regimes in 2000 and 2004 (percent)

	Exporter	Domestic Market Producer		
		Elasticity = -1	Elasticity= -1.1	Elasticity= -0.9
ROE – 2000	6.9	21.8	13.4	30.1
ROA – 2000	2.1	6.5	4.0	9.0
ROE – 2004	28.0	37.1	27.8	46.4
ROA – 2004	8.4	11.1	8.3	13.8

Source: Authors' calculations.

By comparison, the results under the incentive structure of 2004 tell a very different story. Although producing for the domestic market continues to be more profitable than producing for export when the elasticity of demand is one or less, the gap is much narrower than before. Moreover, the two producers make the same rate of return when the demand is elastic. In other words, trade liberalization and exchange rate devaluation/depreciation have essentially eliminated the bias against exports. Not surprisingly, merchandise exports in Egypt have picked up significantly over the last couple of years (Figure 2). This increase, which is mainly due to exchange rate adjustment, is expected to become even more significant as the full impact of trade liberalization is realized.

Figure 2. The Evolution of Merchandise Exports in Egypt (3rd Quarter 2000/01- 2nd Quarter 2004/05)



Source: Ministry of Foreign Trade and Industry, *Monthly Economic Bulletin*, various issues.

Notwithstanding the above results, it is important to keep in mind that they only hold under certain assumptions. Exporters are assumed to benefit from the duty drawback scheme and export subsidies. Equally, if not more importantly, they benefit from exchange rate competitiveness, which followed from the floatation of the Egyptian pound in 2003. If these advantages are denied and/or the exchange rate appreciates perceptibly, the export drive may come to a halt. The latter point is particularly important, as the pound has recently shown signs of appreciation.

Trade Liberalization and Relative Openness of the Egyptian Economy

The past few decades have witnessed an unprecedented level of globalization or increasing interdependence among nations. Both developed and developing countries have reduced their tariff and non-tariff barriers, which has led to rapid expansion in international trade. Suffice it to note that global merchandise trade now accounts for 43 percent of world GDP, compared to 27.4 percent in 1999. The question addressed in this section is whether the Egyptian economy has kept pace with trade liberalization in other developing countries.

As a result of recent trade liberalization, the average level of tariffs in the Egyptian economy is now closer to that in other middle-income countries. While the simple average tariff rate in Egypt, excluding beverages and tobacco, is currently above the average for middle-income countries, its weighted tariff rate is relatively lower (Table 3). Additionally, Egypt has eliminated all surcharges on imports, whereas 27 percent of lower middle-income countries currently apply customs surcharges and 19 percent apply statistical taxes.

Table 3. Applied MFN Tariffs, Egypt and Middle-Income Countries (percent)

	Simple average tariffs	Weighted average tariffs	Standard deviation
Egypt	12.1	8.0	12.7
Middle income	10.6	9.9	11.4
Lower middle-income	11.4	9.8	11.1
Upper middle-income	9.4	9.9	11.9

Source: Calculated from *The World Trade Solution* (WITS) software online: http://wits.worldbank.org/witsweb/.

Other things being equal, the similarity of average tariffs between Egypt and middle-income countries suggests that both will have similar ratios of national trade (imports plus exports) to GDP and a similar share of national exports in world exports. This prediction is not supported by data, however. According to the IMF online database, the ratio of Egypt's trade to GDP in 2003 was 37.4 percent, compared to 54 percent for lower middle-income countries. In addition, the share of Egypt's exports in total world exports was 0.08 percent in 2004, while the average for lower middle-income countries, excluding China, was 0.31 percent. This trend held throughout the period 1999-2004.

The low level of trade in Egypt can be explained in at least three ways. The first is that trade reform is too recent to have had a full impact on trade. Over time, firms will make the necessary adjustments to take advantage of the new opportunities offered by openness, leading to an increase in the share of Egyptian trade to GDP and in world exports.

Secondly, firms in Egypt continue to face constraints regarding entry, operation and exit that make it difficult for them to compete successfully in international markets. Past reforms have improved the business environment, most notably by reducing corporate taxation and easing entry. However, the World Bank (2005) indicates that the processes of obtaining credit, registering property and resolving insolvency are still more costly in Egypt compared to other middle-income countries. For example, registering property and resolving insolvency in Egypt take up to 193 days and 4.2 years respectively, compared to only 80 days and 3.4 years for middle-income countries.

The third possible explanation is the persistence of some trade-related barriers. Although Egypt implemented the WTO customs valuation system and launched the Model Customs Tax Center (MCTC), there is still more to be done especially to conform to international standards and technical requirements. These issues have been highlighted by the EU and the US— Egypt's major trading partners— in their review of barriers to trade in Egypt.

More broadly, Egypt does not lag significantly behind other developing countries with respect to openness, especially after the recent trade liberalization. If further trade liberalization is needed, it should involve fine-tuning of the tariff structure and further improvement of trade-related institutions. Where significant reforms are still needed is in relation to relaxing the most binding supply-side constraints.

Concluding Remarks and Policy Implications

The motivation for this *Policy Viewpoint* was to determine whether the recent trade liberalization has made relative protection in Egypt more uniform across sectors, and whether this reform, along with exchange rate flexibility, eliminated the anti-export bias. In addition, the intention was to explore whether trade liberalization in Egypt has gone far enough or too far relative to other developing countries.

The key conclusions can be summarized as follows. Although trade liberalization has reduced the level and dispersion of tariffs, effective rates of protection facing different industries remain far from even. Second, these reforms, along with exchange rate devaluation/depreciation, have reduced the bias against exports, but there is concern over exchange rate competitiveness in the future. Finally, on whether trade liberalization in Egypt has gone far enough or too far, data indicate that Egypt compares reasonably well with other developing countries.

Looking ahead, further significant trade liberalization in the short run is not urgent. What is urgent, however, is to:

- Reduce the dispersion in effective rates of protection to improve resource allocation. In industries where ERPs are excessively high (e.g., the automobile and clothes and footwear industries), required reforms go beyond changing the trade regime to devising detailed restructuring strategies to put these industries on a sustainable growth path. More efforts are also needed to reduce trade-related barriers, especially regarding international standards and technical requirements.
- Maintain pro-export policies, the most critical of which is related to exchange rate competitiveness in the context of a monetary policy of inflation targeting.
- Enable firms to take advantage of a more liberalized trade regime, essentially by adopting measures to reduce transaction costs, improve contract enforcement, and enhance policy predictability. After all, trade liberalization may be a necessary condition for improving efficiency, but it is by no means a sufficient condition.

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