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The Future of Egypt-U.S. Economic Relations

Policy Viewpoint is intended to contribute to the discussion of ideas and policy options for enhancing economic development in Egypt. The series is based on research conducted by ECES. The content and recommendations are endorsed by the Center's Board of Directors.

Notwithstanding the strong political ties between Egypt and the U.S., the economic relationship between the two countries is not sustainable. The stubborn trade deficit in favor of the U.S., the limited U.S. foreign direct investment (FDI) in Egypt and the dwindling economic aid all suggest that the time has come for both parties to reformulate this dimension of their relationship. Based on the premise that the two countries value their political alliance for peace and stability in the Middle East, the secure supply of oil, and the role of Egypt as a reform model for other countries in the region, this *Policy Viewpoint* is intended to contribute to the debate on the future of Egypt-U.S. economic relations.

After evaluating the current economic relationship between Egypt and the U.S, the *Viewpoint* evaluates alternative options for the future. Based on the analysis, it argues in favor of the creation of an Egypt-US Free Trade Agreement (FTA). It concludes by discussing the nature of a desirable agreement and the steps that should follow.

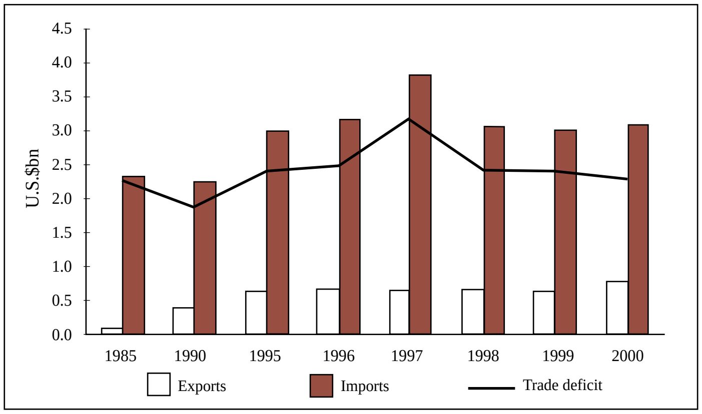
The Current Economic Relationship between Egypt and the U.S.

Judging by the patterns and levels of trade, investment and aid between the two countries, it is difficult to escape the conclusion that the economic relationship between them is incompatible with their strong political ties. The main weaknesses in the relationship are elaborated below.

Trade Deficit in Favor of the U.S.

While Egyptian exports to the U.S. have remained fairly stagnant over the past 10 years, Egyptian imports from the U.S. have consistently been much higher (Figure 1). This pattern of trade has led to a deficit in favor of the U.S. of more than US$ 2.5 billion per year, which, although relatively small from a U.S. perspective, accounts for about 3 percent of GDP in Egypt. Effort on both sides is therefore needed to increase market access for Egyptian exporters in the U.S. markets and to adopt reforms to improve their competitiveness.

Figure 1. Egypt-U.S. Trade Balance, 1985-2000

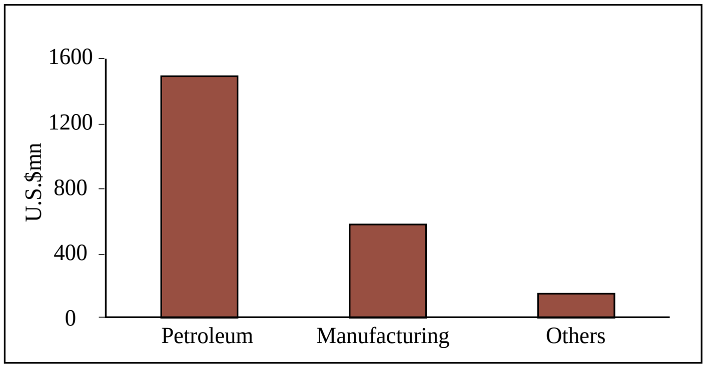


Source: U.S. Census Bureau: www.census.gov/foreign-trade/balance/c7290.html.

Low U.S. Investment in Egypt

U.S. FDI in Egypt is relatively modest, amounting to only US$ 2.2 billion at the end of 1999. This level of investment is much lower than U.S. FDI in countries like Brazil, which received as much as US$ 38.0 billion, and Mexico, which received US$ 26.0 billion. Furthermore, of this limited U.S. FDI in Egypt, 68 percent is concentrated in the oil sector (Figure 2). In order to be able to attract more FDI from American investors, Egypt needs to continue its reform efforts. Yet, at the same time, the U.S. can play an important role in supporting these reform initiatives. The question is: What is the appropriate vehicle for providing such support?

Figure 2. Sectoral Distribution of U.S. FDI in Egypt, 1999

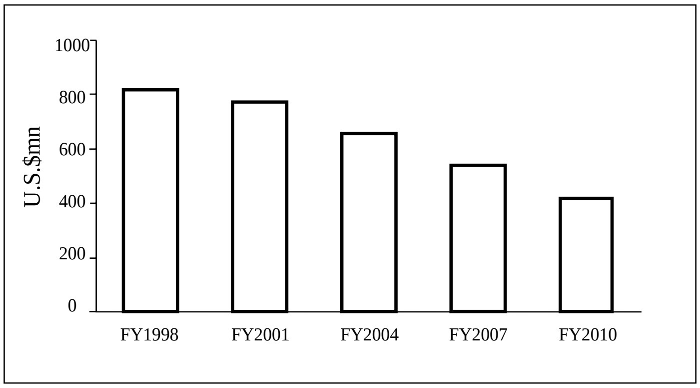


Source: U.S. Department of State, *2000 Country Reports on Economic Policy and Trade Practices.*

Dwindling Aid

Since 1979, Egypt has been second only to Israel as the largest recipient of aid from the U.S. Between 1979 and 2001, total U.S. aid to Egypt amounted to around US$ 54.5 billion – breaking down into US$ 35.4 billion in military assistance and US$ 19.1 billion in economic assistance. While annual economic assistance has averaged around US$ 815 million for the last 20 years, the current plan is to phase out this component of aid by some US$ 40 million a year, leading to a reduction of half by 2010 (Figure 3).

Figure 3. Anticipated Reductions in U.S. Economic Assistance to Egypt, 1998 - 2010



Source: The U.S. Embassy, *Economic Trends Report: Egypt, July 2000.*

U.S. aid to Egypt undoubtedly contributed to the relaxation of the resource constraint facing its economy. Military aid saved resources that would have had to have been raised, in part or in full, internally or externally. Economic aid helped in the expansion of infrastructure and the support of policy and institutional reforms. As the level of economic aid diminishes over time, there is a need to find alternative mechanisms to compensate for the decline in resources and to continue the support of reform.

Options for the Future

When considering the options for the future mode of economic relations between Egypt and the U.S., two seem relevant. The first is to do nothing and let things evolve naturally. The second is to form a free trade agreement (FTA). Both options are assessed below.

Doing Nothing

By doing nothing, both parties are likely to be worse off. The Egyptian economy will suffer from trade diversion following the signing of the impending FTA with the EU. It will be affected by the decline in U.S. economic assistance. Finally, it will lose some support to its reform effort. As a result, the Egyptian economy may not be able to develop fast enough to improve the living standard of its growing population.

For the U.S., there will be economic losses too, although they are small relative to the size of the U.S. economy. On the trade front, U.S. exports to Egypt will diminish as economic aid declines and as Europeans gain duty-free access to Egypt under the Egypt-EU FTA. U.S. investors may also lose an enlarged market, as Egypt is currently forming FTAs with the EU,the Common Market for Eastern and Southern Africa (COMESA) and Arab nations. While difficult to measure, the most important loss to the U.S. may be political in nature, especially if Egypt is not fully equipped to facilitate the peace process and contribute to regional stability.

Entering into an FTA

Entering into an FTA is a more viable option than doing nothing. An FTA would make a smooth transition from aid to trade. It would signal U.S. commitment to Egypt. It would put into effect a workable alternative mechanism for a sustainable economic relationship between the two countries. Moreover, if the agreement is well conceived and implemented, it could generate benefits to both countries.

The impact of such an FTA has been estimated quantitatively. For Egypt, Hoekman, Konan and Maskus (1998) used a general equilibrium model to study the effects of an NAFTA like agreement with the US, on top of Egypt's FTAs with the EU and Arab countries. According to their estimates, the impact of such agreements on GDP would be 1.8 percent annually. This gain does not include the likely increase in investment (as happened in Mexico after the NAFTA) and improved productivity. Nor does it include the benefits associated with the enhanced credibility that countries gain from making external commitments.

For U.S. exporters, the same study estimates the "opportunity cost" of not concluding an FTA with Egypt at around US$ 1.7 billion. Further, Robert Lawrence (1998) finds that an FTA with Egypt would not cause a reduction in employment in the U.S., but a modest increase due to trade expansion. He argues nevertheless that the main benefits to the US are political in nature, given that Egypt's growth and stability are good for peace and modernization in the Middle East.

The Nature of a Desirable FTA

The proposed Egypt-U.S. FTA could take a number of forms. It could be shallow, involving only trade liberalization. It could be deep, of the NAFTA variety, involving the elimination of trade barriers, the liberalization of services, mutual agreement on investment, and the harmonization of domestic policies (especially of labor, environment and intellectual property rights). Or, it could be eclectic, involving liberalization of trade and services, mutual agreement on investment, and the harmonization of *some* domestic policies. The exceptions in the latter case relate to instances where the adoption of one country's standards for certain policies may be costly for the other to adopt in view of differences in their levels of development.

Several factors support the view that the third proposal is the most appropriate for an Egypt-U.S. FTA. From the Egyptian perspective, an FTA of the eclectic variety would help Egypt access the U.S. market, promote the flow of investment to Egypt and provide impetus for further reform. However, while it would serve the interests of Egypt to adopt new intellectual property rights, it may not be as beneficial to adopt the U.S. level of environmental standards.

From the U.S. perspective, an eclectic FTA would be consistent with the shift in the U.S. trade policy since World War II, which came to rely on a two-track approach: multilateralism and regionalism. It would also be consistent with the most recently devised form of FTAs in the context of NAFTA.

Next Steps

In recognition of the need for a more sustainable economic relationship between the two countries, the U.S. and Egyptian administrations agreed in April 1997 to explore the possibility of an FTA between the two countries. Since then, several meetings have been held. A Trade and Investment Framework Agreement (TIFA) agreement was signed in 1999, setting the stage for formal negotiations on an FTA.

The next steps involve at least two types of actions: (1) mobilizing support for an FTA on both sides of the Atlantic; and (2) ironing out issues of contention. On mobilizing support, spreading the fact that an FTA is in the interest of both countries is key. This is best led not only by policy makers, but also by the private sector, and think-tanks. Ironing out differences on specific details will take serious negotiations and time, which are better started sooner rather than later. While such negotiations are tedious and highly politicized, their conclusion seems possible given the full recognition on both sides that what is at stake is much more than an economic deal.

This Policy Viewpoint draws on papers in Building Bridges: An Egypt-U.S. FTA, Galal, Ahmed and Robert Z. Lawrence eds. (1998), Brookings Institution.

This Policy Viewpoint was written by Ahmed Galal, ECES.

For more information about the Center and its publications contact:

The Egyptian Center for Economic Studies
World Trade Center - 1191 Corniche El Nil,
14 th Floor - Cairo 11221 - Egypt.
Tel.: (202) 578 1202 *Fax.: (202) 578 1205*
E-mail: eces@eces.org.eg *URL: www.eces.org.eg*