



**New Trends in Egypt's Trade Policy
and Future Challenges**

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Abstract

This paper analyzes Egypt's trade policy reforms since 1980 to evaluate the general openness of the economy. Changes in tariffs, additional taxes and subsidies, non-tariff barriers and the exchange rate system are surveyed as indicators of liberalization trends in the economy. The analysis extends beyond the status quo and considers the future of trade liberalization in light of Egypt's involvement in multilateral, regional and bilateral trade agreements with the European Union, the United States, Eastern and Southern Africa, and Arab countries. The paper identifies the challenges to future liberalization of Egypt's trade, including the prospect of strong competition abroad. Subcontracting, maintaining a responsive exchange rate, improving the indicators of competitiveness are among the recommendations for increasing Egypt's integration in global trade.

ملخص

تتناول الورقة تحليلاً للإصلاحات التي لحقت بالسياسات التجارية منذ بداية الثمانينات بهدف تقييم درجة الإنفتاح العامة للاقتصاد. وقد تم عمل مسح شامل للتغيير في الرسوم الجمركية، والضرائب الإضافية، وإعانات الدعم، والعوائق غير الجمركية، ونظام الصرف الأجنبي باعتبارها مؤشرات لاتجاهات التحرير في الاقتصاد. كما يمتد التحليل إلى ما هو أبعد من تقييم الوضع الحالي إلى النظر لمستقبل تحرير التجارة في ضوء الاتفاقات المتوقعة للتجارة مع الاتحاد الأوروبي، والولايات المتحدة الأمريكية، وشرق وجنوب أفريقيا والدول العربية. وتحدد الورقة تحديات المستقبل بالنسبة لتحرير التجارة المصرية، بما في ذلك احتمالات المنافسة القوية في الخارج. ومن بين التوصيات التي وردت في الورقة والتي تستهدف زيادة اندماج مصر في التجارة العالمية: التعاقد من الباطن، والمحافظة على وجود سعر صرف مرن، وتحسين مؤشرات القدرة التنافسية.

List of Acronyms

AFTA	Arab Free Trade Agreement
CACM	Central American Common Market
CAP	Common Agricultural Policy
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
DRC	Domestic Resource Cost
ERER	Effective Real Exchange Rate
ERP	Effective Rate of Protection
EU	European Union
FTA	Free Trade Agreement
GSP	Generalized System of Preferences
MFA	Multi-Fiber Agreement
MFN	Most Favored Nation
NAFTA	North America Free Trade Agreement
NRP	Nominal Rate of Protection
NTB	Non-trade Barrier
OECD	Organization for Economic Cooperation and Development
REER	Real Effective Exchange Rate
TIFA	Trade and Investment Framework Agreement
WTO	World Trade Organization

I. Introduction

After decades of protectionist theories and industrialization policies based on import substitution, in the 1980s, economists began advocating development strategies based on trade liberalization and export promotion. The debt crisis of 1982, the poor performance of the inward-oriented economies compared to the outward-oriented, rapidly-growing East Asian countries and the collapse of the communist system all played an important role in reshaping policy views (Edwards 1993). Since 1983, the pace of global trade in goods and services has accelerated and outpaced the expansion of the world GDP. In the early 1990s, the elasticity of trade to GDP jumped to above two and the ratio of exports to GDP reached 25 percent in 1995 (European Commission 1997).

On the whole, developing countries followed this trend. They have become more open over time, and for most developing countries, trade liberalization has been a gradual process. It usually begins with exchange controls, followed by nontariff barriers and eventually tariffs (Andriamananjara and Nash 1997). In the case of Egypt, it was the first among the Middle Eastern and Arab countries to adopt a trade liberalization policy during the 1970s (Wilson 1986).¹ But how have liberalization trends evolved in the Egyptian economy since then?

This paper surveys the reforms in Egypt's merchandise trade policy since 1980 to date to evaluate their impact on the openness of the economy. The analysis also considers the future prospects for trade liberalization in Egypt in light of its current and future involvement in multilateral, regional and bilateral trade agreements. The ultimate objective is to identify the upcoming challenges Egypt will face as it moves towards a more liberal foreign trade sector.

This paper is organized as follows. Section II briefly outlines the salient features of Egypt's foreign trade sector. Section III traces the progress of trade liberalization and openness in the Egyptian economy since 1980. Section IV discusses the future of trade liberalization in Egypt. Section V highlights the future challenges, and Section VI concludes.

II. The Main Features of Egypt's Foreign Trade Sector

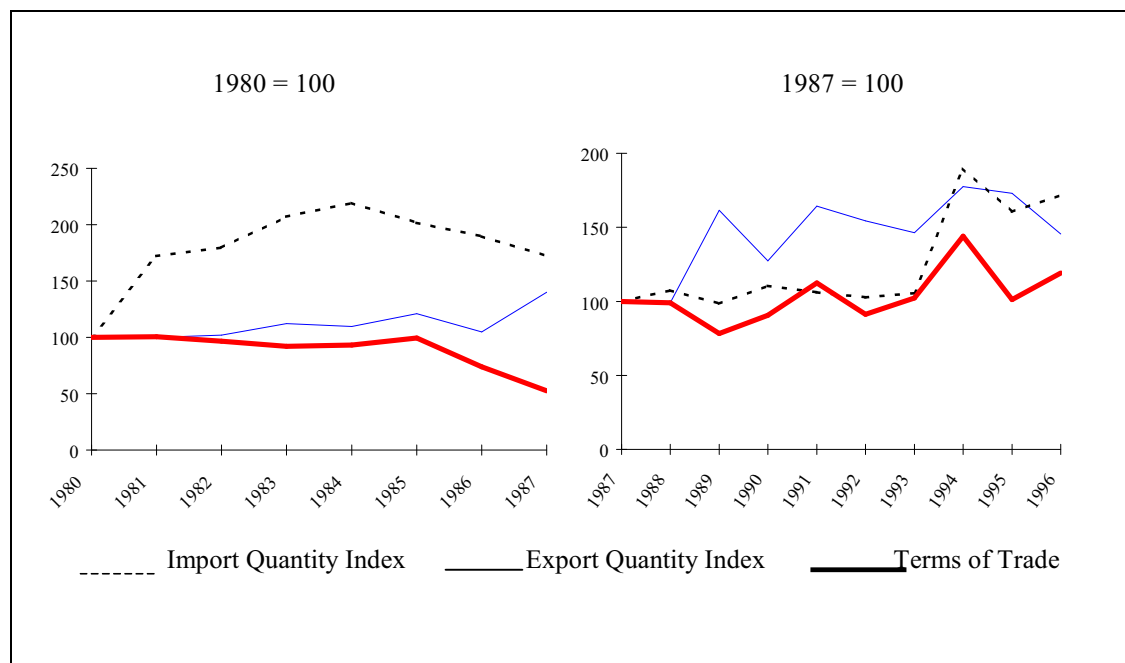
Egypt's trade balance has been continuously in deficit throughout the whole period of the study, from 1980 to 1998. The gap between exports and imports has been increasing since 1981 at an average annual growth rate of 18 percent. In 1997, the

¹ Trade liberalization is defined as a reduction in trade restrictions and an increase in the use of prices instead of discretionary intervention.

share of the trade deficit in GDP was 11 percent, and it has remained in this range since the beginning of the Economic Reform and Structural Adjustment Program (ERSAP) in 1991.

The developments in Egypt's trade balance have had different underlying factors over time. Before 1988, the gap between exports and imports widened mainly due to an upsurge in the volume of imports, especially that of raw materials and investment goods. This trend was reinforced towards the end of the study period by a deterioration in Egypt's terms of trade (Figure 1). Between 1988 and 1993, the trade deficit fluctuated. These fluctuations were closely linked to the changes in the quantities of Egypt's exports. From 1994 onwards, the deficit has been steadily expanding due to increases in the quantities of imports that outweigh the improvements Egypt has witnessed in its terms of trade for some years.

Figure 1. Exports and Imports Quantity Indices and Terms of Trade, 1980 to 1996



Source: Calculated from CAPMAS, *Foreign Trade Indices*, different issues.

The trade deficit is problematic not only because it is growing, but also because the way it is financed embodies risk, which could have a negative impact on Egypt's balance of payment as a whole. A considerable amount of the financing is closely related to foreign aid and to oil—mainly through the foreign direct investment concentrated in the oil sector and workers' remittances that are indexed to the oil revenues of the Gulf region (Petri 1997). Add to this, that oil and its products account for about half of total export revenues. In 1996/97, the official transfers represented 33 percent of the trade deficit and the net private transfers formed another 9 percent.

Export coverage of imports was only 33 percent with petroleum exports accounting for 52 percent of the total merchandise exports.

Egypt's exports remained concentrated in a handful of categories for the whole period of the study. The most important export category was mineral products, accounting for 58 percent of total Egyptian exports in 1984 and 47 percent of exports in 1996. The second most important export was textiles and clothing (26 percent in 1984 and 23 percent in 1996), followed by vegetable products (7 percent in 1984 and 10 percent in 1996), base metals and related products (5 percent and 8 percent in the two respective years), and chemical products (2 percent in 1984 and 5 percent in 1996). Within these export categories, the importance of some products increased while that of others decreased.² These changes translated to an increase in the share of manufactured goods in total Egyptian exports from 20 percent in 1984 to 44 percent in 1996 with woven cotton, cotton yarn, aluminum ingots, and bleached rice on the top of the list. Nevertheless, the performance of manufactured exports and Egypt's merchandise exports in general, have been disappointing especially when compared to China, Southeast Asian countries and the Central and Eastern European countries (Sachs 1996).

Egypt's imports are more diversified than its exports. In 1996, 94 percent of total imports were concentrated in 11 product categories, while 94 percent of total exports were concentrated in only five product categories. Machinery and vegetable products remained the most important imports between 1984 and 1996. Some import categories, as measured by their share of total imports, declined significantly, such as vehicles (from 12 percent in 1984 to 5 percent in 1996), mineral products (from 9 percent to 4 percent) and living animals and related products (from 7 percent to 4 percent). The share of other import categories in total imports increased, including: paper, paper-making materials and related articles (from 2 percent to 4 percent); artificial resins, plastic materials, cellulose and rubber (from 3 percent to 6 percent); and fats, oil and related products (2 percent to 4 percent). The remaining import categories maintained their importance over time.

² There was an increase in the significance of refined petroleum in the minerals category (from 7 percent of mineral exports in 1984 to 32 percent in 1996) at the expense of crude petroleum (81 percent to 49 percent). In 1996, raw cotton accounted for no more than 11 percent of the textile exports compared to 50 percent in 1984, whereas readymade garments and non-cotton textile exports increased over time. Aluminum bars, which represented about 80 percent of total base metal exports, accounted only for 2 percent in 1996.

The direction of Egypt's trade changed significantly over the past 10 years. While the share of exports to the United States quadrupled between 1986 and 1996, the share of exports to the Eastern Bloc declined, as did the imports from this region. Currently, Egypt's major trading partners are the European Union and the United States. In 1996/97, they absorbed 66 percent of Egypt's exports and supplied Egypt with 65 percent of its import needs. Egypt's trade with the Arab countries is by far less significant. In the same year, only 10 percent of Egypt's exports were destined for Arab countries, and only 4 percent of Egypt's imports came from there (Table 1).

Table 1. Distribution of Egypt's Exports, Imports and Trade Deficit by Trading Partner 1986/87 and 1996/97 (percent)

	Exports		Imports		Trade Deficit	
	1986/87	1996/97	1986/87	1996/97	1986/87	1996/97
European Union	39	34	40	41	-41	-45
United States	8	32	20	24	-24	-20
Arab Countries	12	10	1	4	2	-1
Other African and Asian Countries	11	16	11	14	-11	-13
Others	30	8	27	17	-26	-21

Source: Central Bank of Egypt, *Economic Review*, different issues.

III. Changes in Egypt's Trade Policy and the Impact on Trade Openness

Egypt began the 1980s with a much less restrictive trade regime compared to the period from 1958 to 1973 due to the trade liberalization policies implemented in the mid-70s. Liberalization measures included eliminating the state monopoly on importation (by virtue of the Export-Import Law No.118/1975), introducing the Own Import System, phasing out bilateral trade agreements and creating free trade zones (Wilson 1986).³

These measures focused mainly on liberalizing payments rather than reducing tariffs and nontariff barriers to trade. This is why, at the beginning of the 1980s, the tariff rates were high and nontariff barriers were used extensively.⁴ The distortive effects of the trade policy were further aggravated by the prevalence of the multiple exchange rate. But how did trade reform proceed during the following years? Have there been significant shifts in the trade liberalization trends? Have the trade policy reforms led to greater or less openness of the Egyptian economy? This section

³ According to the Own Import System, the private sector is allowed to use its foreign exchange earnings to finance import purchases.

⁴ Over the period 1981 to 1985, the unweighted average Most Favored Nation (MFN) tariff in Egypt was 47.4 percent compared with 29.5 percent in Latin America, 26.3 percent in the Middle East and North Africa, and 20.3 percent in East Asia. Between 1984 and 1987, the percentage of tariff lines

attempts to answer these questions. First, the analysis focuses on the changes that occurred in the main trade policy instruments over the period of the study and then traces the impact of these changes on trade openness.

Trade Liberalization Trends: Changes in Trade Policy Instruments

In general, there are three main indicators of change towards trade liberalization: changes in tariffs and additional taxes and subsidies; changes in the nontariff barriers (NTBs) to trade; and changes in the exchange rate system. Lowering the average level and dispersion of rates of protection and reducing the coverage and level of NTBs lead to more liberalization. A shift from multiple exchange rates to a uniform rate and a real devaluation also constitute a step towards liberalization. Unification of the exchange rate removes discrimination between tradable activities, and devaluation reduces the pressure of quantitative restrictions on rationing imports and reduces anti-export bias (Papageorgiou et al. 1991).

The changes in each of these indicators are discussed in detail next. It should be noted that these changes began with the tariff reforms in August 1986 and continued with the announcement of the ERSAP. The latter included a trade liberalization component that aimed at changing Egypt's inward-oriented, import-substitution strategy of the past decades.

Changes in Tariffs, Taxes and Subsidies

1. Tariff-based Protection

Over the period of this study, tariffs have undergone several changes that constitute a clear move towards liberalization and the beginning of an efficient use of tariffs as a policy instrument. First, the averages of both the nominal effective rate of protection (NRP) and effective rates of protection (ERP) have declined over time as shown in Table 2 below.⁵ The collection rate—the ratio of import duties collected to the value of imports—has also been steadily declining from 21 percent in 1991/92 to 17 percent in 1995/96 and further to almost 17 percent in 1996/97. It is expected that the collection rate will continue to decrease in the future to reach 15 percent in 1998/89 (International Monetary Fund 1998b).

affected by nontariff barriers in Egypt was 48 percent compared with 40.1 percent in Latin America, 35.6 percent in the Middle East and North Africa, and 30 percent in East Asia.

⁵ ERP takes into consideration tariffs on inputs and output. It may be defined as the excess of the domestic value added (value added under the prevailing tariff structure) over the international market value added (value added in absence of nominal protection). It thus reveals the incentive structure prevailing in the economy due to domestic policies.

Second, the tariff dispersion, as measured by the range of nominal tariffs and the standard deviation of the NRP and ERP, has been decreasing.⁶ The maximum tariff rate declined from 110 percent in 1986 to 100 percent in 1992, 80 percent in 1993, 70 percent in 1994, 50 percent in 1997, and further to 40 percent in 1998. The standard deviation of the tariffs has also declined (Table 2). Yet, the existing pattern of protection discriminates against activities with a comparative advantage. The rank correlation coefficients between domestic resource cost (DRC) and between the NRP and ERP in 1997 were estimated at 0.44 and 0.45, respectively (Nathan Associates 1998). Inefficient sectors that are favored include beverages, furniture and means of transportation, while efficient sectors that are not favored include cotton ginning. This pattern of protection has had its impact on resource allocation within the Egyptian economy. The most striking example is the cotton and ginning industry that has a comparative advantage but is effectively negatively protected. Discrimination against this industry was associated with a 50 percent decline in its share of total industrial output from the early 1980s to 1995/96.

Table 2. Nominal and Effective Protection (percent)

	Nominal				Effective			
	1986*	1994	1996	1997	1986	1994	1996	1997
Agricultural food products	31.0	8.9	7.0	6.8	38.0	8.8	6.8	6.6
Agricultural non-food products	---	15.7	9.5	9.5	---	16.4	9.6	9.6
Livestock products	12.0	5.0	5.1	5.1	113.0	3.3	4.1	4.2
Food processing	8.0	8.4	6.9	6.9	17.0	7.5	6.3	6.4
Cotton ginning	0	5.0	5.0	5.0	-68.0	-24.6	-10.9	-11.0
Spinning and weaving	34.0	37.6	29.0	28.0	788.0	68.2	49.8	47.6
Readymade garments	109.0	69.6	50.8	46.6	348.0	87.3	61.8	55.9
Leather and leather products (excl. footwear)	16.0	46.6	33.7	33.1	35.0	79.6	52.7	47.6
Footwear	51.0	63.9	41.4	39.1	160.0	94.1	53.6	50.8
Wood and wood products (excl. furniture)	42.0	11.0	8.7	8.6	40.0	6.8	6.0	6.1
Furniture	110.0	69.8	54.9	49.9	296.0	128.8	95.2	83.8
Paper and printing	16.0	17.1	17.4	17.1	36.0	17.6	18.3	17.8
Chemicals	15.0	11.1	10.1	10.0	75.0	9.2	9.1	9.2
Rubber, plastic and related products	28.0	33.0	29.8	28.5	563.0	50.0	45.6	43.1
Porcelain, china and ceramics	75.0	52.5	37.9	35.0	214.0	90.8	60.9	56.0
Glass products	36.0	33.2	21.2	20.7	54.0	39.4	23.8	23.2
Non-metal products	6.0	23.1	15.4	15.2	1.0	29.0	18.4	18.5

⁶ Tariff dispersion in Egypt stems from the escalating nature of its tariff structure. A decline in this dispersion is a favorable development given that a non-uniform tariff structure distorts production and investment incentives by making some sectors more attractive than others.

Steal, iron and metal products	17.0	23.0	17.2	16.1	120.0	26.4	19.4	18.1
Machinery and equipment	28.0	22.5	16.0	15.3	39.0	22.5	15.0	14.5
Means of transportation	60.0	52.7	45.7	44.0	628.0	65.0	57.8	55.6
Unweighted average	36.5	30.5	23.1	21.9	184.1	41.3	30.2	28.2
Standard deviation	32.0	21.9	16.1	14.8	237.6	39.7	27.4	24.7

* After August 1986 tariff revisions.

General Notes:

1) Calculations for 1986 are based on the 1983/84 input-output tables, the rest are based on the 1991/92 input-output tables. It should be noted that the 1986 ERP estimates are less reliable than the 1990s ERP estimates because calculations of ERP ignore the effect of price controls, indirect taxes and subsidies, multiple exchange rates and overvaluation that were more severe in the 1980s compared to the 1990s.

2) Industries with a high positive ERP or below -100 percent will attract resources to them. Those with an ERP between -100 percent and zero squeeze out resources.

Source: For 1994, 1996 and 1997: Kheir El-Din, Hanaa (1998), "Effective Protection in Egypt Due to the Tariff Structures in 1996 and 1997 Compared to 1994," a study prepared for USAID/DEPRA; for 1986: Kheir El-Din, Hanaa (1989), "Evaluation of Protection and Anti-export Bias in the 1986 Customs Tariffs in Egypt," *L'Egypte Contemporaine*, No. 417.

Third, the extent of the economy-wide bias against exports decreased over the past few years from 25.7 percent in 1994 to 18.2 percent in 1997 (Table 3).⁷ At the disaggregate level, the bias decreased in all economic activities except cotton ginning where it remained almost constant, and paper and printing and livestock, where there was a slight increase in the bias against their potential exports.

Table 3. Changes in Tariff-induced Bias against Exports (percent)

	1994	1997
Agricultural food products	8.49	6.48
Agricultural non-food products	15.40	9.25
Livestock	4.26	4.50
Food processing	5.26	4.45
Cotton ginning	4.99	5.00
Spinning and weaving	32.69	24.44
Readymade garments	65.49	43.98
Leather Products (excl. footwear)	42.72	28.12
Footwear	60.95	36.98

⁷ Export bias, B_x , against activity j , i.e., (B_{xj}) occurs when domestic prices exceed export prices thus making production for domestic market more profitable. This is calculated as:

$$B_{xj} = \left\{ \frac{1 + t_j}{1 + s_j} - 1 \right\} \times 100,$$

where t_j = nominal tariff rate on activity j , and s_j = export subsidy rate or the duty drawback per £E of exports and is calculated as:

$$\sum_i t_i \times m_{ij}, \text{ the technical coefficient of imported commodity } i \text{ per unit value of activity } j.$$

Wood products (excl. furniture)	5.06	4.15
Furniture	64.55	46.24
Paper and printing	7.54	7.59
Chemical products (excl. oil refining)	4.93	4.73
Rubber and plastic products	26.84	23.45
Porcelain products	51.67	34.38
Glass products	27.29	16.91
Non-metallic products	22.75	14.96
Metals and iron products	21.68	15.16
Machinery and equipment	10.75	7.27
Means of Transportation	30.57	26.62
Unweighted average	25.69	18.23

Source: author's calculation.

Despite these tariff reforms, more needs to be done. Egypt's tariff rates are still above the average tariffs prevailing in many other regions. In 1996, the weighted average tariff in Egypt (28 percent) was well above that of East Asia (21 percent), Central Europe (9 percent), Latin America (14 percent), Sub-Saharan Africa (15 percent), and the average for developing countries (21 percent) (Alonso-Gamo et al. 1997). Also, the standard deviation of Egypt's tariffs is substantially higher than that of all countries represented in the World Bank with only a few exceptions (Nathan Associates 1998).

2. Additional Taxes and Fees

Egypt's Law No. 87 of 1986 eliminated a series of taxes and fees that were formally levied on imports such as the statistical duty, subsidy tax, marine duty, and municipal tax. Currently, the Egyptian Customs Authority levies a 2 to 3 percent fee on imports depending on the tariff applied. Items with tariffs less than 30 percent are subject to service fees of 2 percent, and items subject to tariffs more than 30 percent pay a service fee of 3 percent. A sales tax of 5 to 25 percent is added to the final customs value of imports (U.S. Dept. of State 1995/96).

In terms of exports, the Egyptian government levies charges on exports that are subject to quality inspection. Examples of these goods are citrus fruits, juices and vegetables. All export taxes were eliminated in late 1992 (International Monetary Fund 1998a).

3. Changes in the NTBs

The importance of the different forms of NTBs in Egypt has varied over time. The significance of import bans, as measured by their production coverage, is declining (Table 4). The import ban list, instituted in 1986 as a replacement for the import-licensing system abolished in the same year, now covers only poultry parts, certain textiles and apparel items, down from 210 items in 1990. These

account for less than 4 percent of domestic production. As part of the Uruguay Round (UR) Agreement, Egypt agreed to remove the import ban on clothing by January 1, 2001; however, products removed from the import-ban list are sometimes subject to high duty rates. The tariff on whole poultry, removed from the ban in July 1997, was set at 80 percent. Also, Egypt imposed a tariff of 54 percent plus a 10 percent sales tax and a 1 percent service fee on textiles removed from the ban list on January 1, 1998. Other items that were removed from the ban list, including meat, fruits, vegetables, household appliances, and transformers, were added to the quality control list (Office of the U.S. Trade Representative and Related Entities 1998).

Quality control is increasingly gaining importance as a NTB to trade, as noted in Table 4. The quality control list now consists of 131 items including foodstuffs, spare parts, construction products, electronic devices, appliances, and many consumer goods. Egyptian standards on imports are considered a trade barrier by the European Union—Egypt's primary trading partner. Product standards set by the General Organization for Export and Import Control are at variance with internationally-recognized standards, thus causing problems with imports from the E.U., such as processed food, ceramic tiles, sanitary ware, and cosmetics (Nathan Associates 1998). All other NTBs listed in Table 4 no longer exist. These include canceling the list of special conditions by Ministerial Decree 288/93, as well as canceling letters of credit and servicing requirements.

Quantitative restrictions on exports include mainly three measures: export quotas, export bans and prior approvals on exports (Kheir El-Din and El Dersh 1992). Ministerial Degree 266/93 eliminated the only remaining item on the list of export quotas. The remaining item on the list of banned exports is raw hides, down from 20 items before 1991, six items in 1991 and two items in 1993. This NTB is scheduled to be removed in 1998 (International Monetary Fund 1998a). In 1991, the number of goods subject to prior approvals was reduced from 37 items to one.

Table 4. Production Coverage of NTBs on Egyptian Imports (percent of domestic production)

	Before 1991			After 1991 Trade Reform			1997		
	Public Sector	Private Sector	Total	Public Sector	Private Sector	Total	Public Sector	Private Sector	Total
Import bans	47.5	64.0	52.9	43.7	32.9	40.7			< 4
Quality control	3.6	21.4	15.8	19.9	21.9	20.5			NA
Prior approvals	12.4	9.5	11.5	0	0	0	0	0	0
Special conditions	8.4	2.6	6.8	0.56	0.51	0.55	0	0	0
Suspension letters of credit	9.2	7.9	8.8	0	0	0	0	0	0
Servicing requirements	6.8	1.5	5.4	0	0	0	0	0	0

Source: Before and after 1991 trade reform: Kheir El-Din, Hanaa et al. (1992), "Trade Policies in Egypt," in Said El Naggar (ed.), *Foreign and intra-regional trade of the Arab countries* (Arabic), Arab Monetary Fund.

4. Changes in the Exchange Rate

In 1980, Egypt had a multiple exchange rate in effect. There were three rates of foreign exchange. The first rate was that of the Central Bank which remained fixed at 0.7£E/US\$ from 1979 until 1989. The Central Bank's sources of foreign exchange were earnings from exports of petroleum, rice and cotton; Suez Canal revenues; royalties from SUMED pipeline; and foreign currency transferred to the government as foreign aid. These proceeds were used to service debt and finance the import of seven basic products: wheat, flour, tea, sugar, vegetables, pesticides, and fertilizers. The second rate was the commercial banks' rate initially fixed at 0.83£E/US\$. The commercial banks' pool included the proceeds from all other exports, tourist payments and workers' remittances. In addition, foreign exchange was traded at a premium in the 'own exchange pool'.

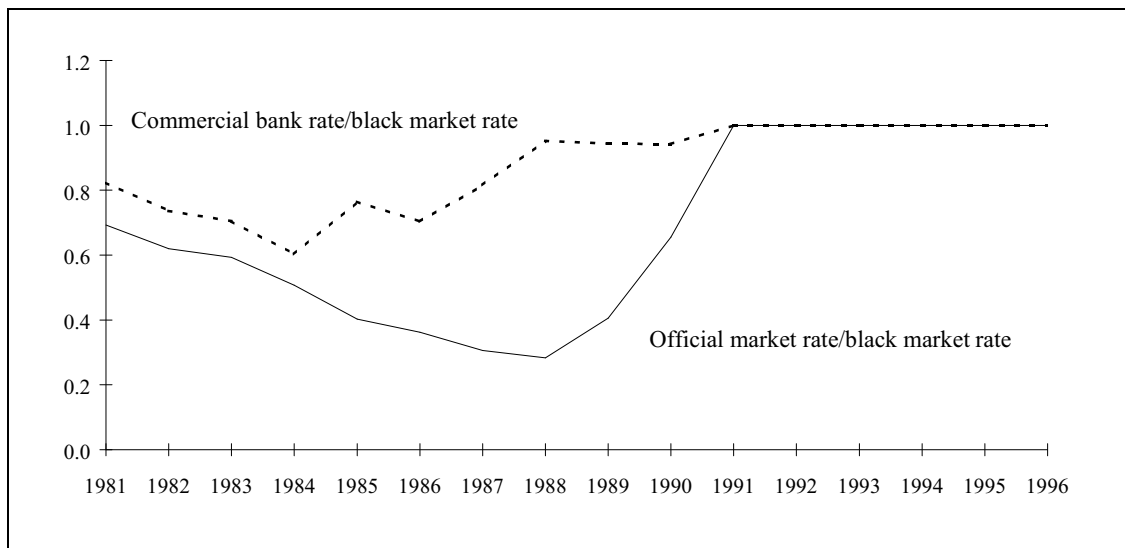
At that time, Egypt faced pressures from its trade balance, in addition to current account imbalances, due to the sharp fall in revenues from the Suez Canal, tourism and workers' remittances. The exchange rate was not actively used, however, to restore external equilibrium, and instead the government resorted to imposing restrictions. This was probably motivated by fear that currency devaluation would fuel inflation. As a partial consequence of this policy, the real effective exchange rate (REER) appreciated by 38 percent between 1982 and 1985, and non-oil exports were discouraged by the overvaluation of the exchange rate (GATT 1993).

By mid-80s, the exchange rate policy in Egypt had to change significantly. This was necessary to attract the remittances of the nearly two million Egyptians then working abroad, and because development and industrialization requirements in Egypt were inconsistent with the overvalued exchange rate (Giacomo 1986). Following pressure from international organizations, Egypt embarked on a gradual reform of the exchange rate. This included both devaluation and gradual simplification of the exchange rate regime. In February 1991, the unification of the exchange rate versus the dollar took place only a few months after limiting exchange markets to two—the primary and secondary markets. The exchange premium effectively became zero in 1991 (Figure 2). This was accompanied by currency devaluation between 1985 and 1991, when Egypt began its stabilization program. No significant devaluation occurred since then and, as a result, there was a real appreciation of the Egyptian pound with the inflation rate in Egypt much higher than that of its trading partners. As measured by the REER, the real appreciation between July 1991 and December 1996 was 30 percent (Subramanian 1997).

Despite this real appreciation of the Egyptian pound, a recent International Monetary Fund study concluded that although the REER was substantially overvalued

before 1993, since then it has moved close to the equilibrium real exchange rate (ERER). At the end of 1996, the REER was estimated to have appreciated only 7 percent compared to the ERER. The reason for this improvement is the significant appreciation of the ERER during the period 1991 to 1995, which can, to a large extent, be attributed to the reduction in the debt-service ratio over this period. Other factors that positively contributed to the appreciation of the ERER were technical progress and, to a lesser extent, the Gulf War. Terms of trade, government consumption and the lagged capital account balance contributed negatively to the appreciation of the ERER (Mongardini 1998). Sources of appreciation show that the appreciation of the ERER may not be sustainable in the future and that the Egyptian pound could be substantially overvalued if the exchange rate continues to be used as a policy anchor.

Figure 2. Exchange Rate Premium, 1981 to 1996



Source: Calculated from the International Monetary Fund, *International Financial Statistics*, different issues.

Changes in Trade Openness

Notwithstanding the trade reforms undertaken by the Egyptian government, measures of openness reveal two facts. First, Egypt exhibited a comparatively low trade profile over the period of the study. Second, its economy has become less open and less integrated in the world economy over time.

Egypt Exhibited a Comparatively Low Trade Profile

This turn inward occurred in spite of the global trend to intensify international trade relationships. Table 5 compares a variety of trade performance indicators for Egypt along with selected fast-growing economies in two periods from 1983 to 1986 and 1993 to 1996. The indicators show that Egypt is the least open economy and is increasingly deviating from the averages of the fast-growing economies. The large public sector, the relatively high tariff barriers, the trade-distorting domestic regulations, and the overall institutional setting within which business is conducted in Egypt, can all be considered contributing factors to the development of Egypt's trade openness.

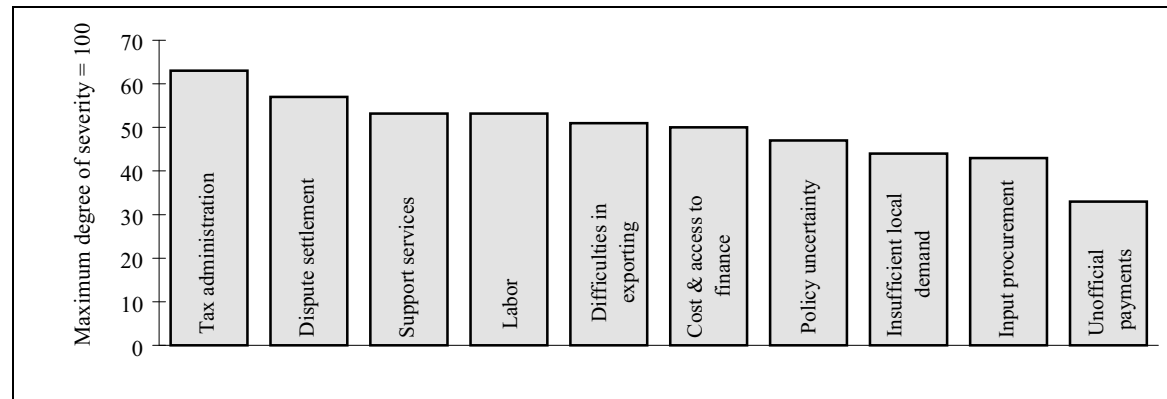
A more favorable business environment would undoubtedly enhance production and exports. Figure 3 illustrates the institutional constraints to business in Egypt as perceived by private firms.⁸ Among the constraints, inefficient regulations on the ports and infrastructure sectors and the inefficiency of the banking system are widely acknowledged as trade barriers. It is estimated that the inefficiencies of the Egyptian

Table 5. Development of Trade Openness in Egypt and Selected Fast-growing Economies

	Share in World Exports		Share in World Imports		Trade to GDP	
	1983-1986	1993-1996	1983-1986	1993-1996	1983-1986	1993-1996
Egypt	0.17	0.07	0.54	0.23	32	25
Thailand	0.41	1.05	0.52	1.31	43	71
Malaysia	0.83	1.40	0.67	1.39	89	160
Indonesia	1.08	0.94	0.69	0.77	42	42
Chile	0.21	0.28	0.15	0.3	44	48
Korea	1.63	2.35	1.58	2.51	64	55
Average (excl. Egypt)	0.83	1.2	0.72	1.26	56.47	75.08

Source: Calculated from the International Monetary Fund, *International Financial Statistics*, different issues.

⁸ This is based on a survey of 154 firms. Split according to size, the sample had 31 percent large firms, 34 percent medium-size firms and 35 percent small firms. According to type of ownership, the sample had 73 percent domestic firms and 27 percent foreign firms. According to economic activity, 64 percent of the firms were in the field of industry, 13 percent trade, 9 percent in construction, 8 percent tourism, and 6 percent in the oil sector.

Figure 3. Overall Ranking of Institutional Constraints in Egypt

Source: Fawzy, Samiha (1998b), "The Business Environment in Egypt," The Egyptian Center for Economic Studies (ECES), Working Paper No. 34.

port services add 10 percent to the cost of imported goods, and inefficient telecommunication services and financial services impose a tax on the manufacturing and agriculture sectors equivalent to 50 and 20 percent, respectively (Nathan Associates 1998).⁹

As Noll (1997) clearly indicates, in the case of a country like Egypt, where direct trade barriers—tariffs—are relatively high, the trade-distorting regulations should not be interpreted as motivated by the desire to impose indirect trade barriers. For Egypt, distorting regulations are the result of overall disadvantageous policies.¹⁰

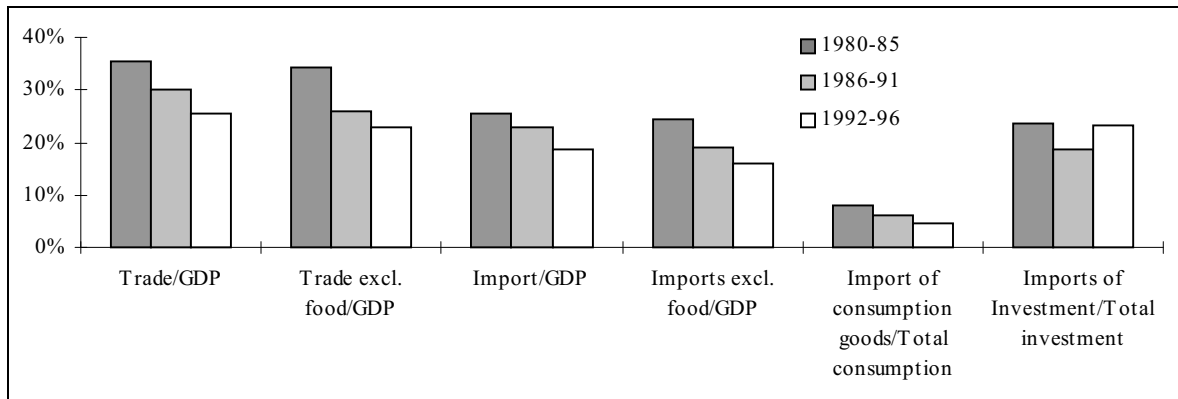
Egypt Has Grown Less Open and Less Integrated in the World Economy

The ratio of total trade imports and exports, to GDP dropped by about 10 percentage points from 1980 to 1985 and 1992 to 1996. Import penetration ratios, another important measure of openness, also reveals this unfavorable trend. The ratio of total imports to GDP declined over the period as did the ratio of imports of consumption goods to total consumption.¹¹ Imports of investment goods declined between 1986 and 1991 but gained momentum in the following period (Figure 4).

⁹ For the financial sector, the real financial spread in Egypt and the European Union were compared, and; accordingly, an implicit tariff of 20 percent was assumed for this sector. A 50 percent tariff equivalent was assumed for the telecommunication sector based on comparing the number of employees per line in Egypt to the world average.

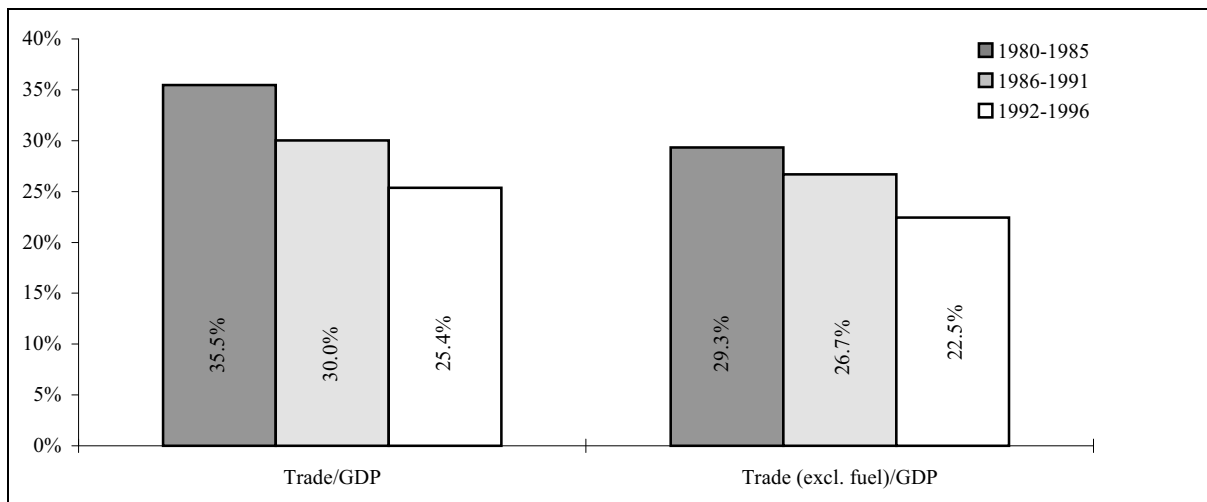
¹⁰ See Noll (1997) for a discussion of trade opportunities in Egypt that are hindered by existing policies.

¹¹ This version of the import penetration ratio is a useful indicator since it is the imports of consumption goods that are usually mostly restricted (Andriamananjara et al. 1997).

Figure 4. Outcome-based Measures of Trade Liberalization

Source: GDP from the International Monetary Fund, *International Financial Statistics*, different issues; all other data from CAPMAS, *Statistical Yearbook*, different issues.

The declining significance of trade in the Egyptian economy can be partly attributed to the importance of oil in Egypt's trade and the volatility of its prices. During the 1970s and early 1980s, when there was a remarkable rise in oil prices, Egypt's share in world exports and imports and its trade share in GDP were higher than in the years that followed (Petri 1997). If the openness indicator of trade/GDP is calculated excluding Egypt's trade in fuel, Egypt's openness still declined over time but at a lower rate (Figure 5). Windfall gains to the economy from oil and other sources also contributed to Egypt's trade performance. They helped raise the price of non-tradables versus tradables and thus attracted investment away from the tradable sectors. Egypt's structural adjustment program has also played a role by suppressing imports during its early stages (World Bank 1995a).

Figure 5. Openness Indicators, Excluding Trade in Fuel

Source: author's calculations.

IV. Future Directions for Egypt's Trade Liberalization

Liberalization trends in the Egyptian economy are expected to continue in the future based on the trade agreements that Egypt has already signed and is currently negotiating. This section explores the impact

of Egypt's multilateral, regional and bilateral trade arrangements on the liberalization of the Egyptian economy besides what they can offer Egypt in terms of market access.

Multilateral Liberalization

Egypt's unilateral liberalization efforts were essential for allowing its full participation in the UR negotiations, and the UR Agreement has in turn locked in these reforms. On one hand, under the UR Agreement, Egypt binds 100 percent of its tariff lines in agriculture and 97 percent of its tariff lines in industry, thus approaching the commitments of the OECD countries and surpassing those of many other developing countries. After the full implementation of the UR Agreement commitments, however, Egypt's final bound tariffs to both agriculture and industry will be greater than the tariffs applied in December 1995 and the current applied tariff rates. Only 10 percent of all tariff lines will eventually have tariffs lower than the applied tariffs in December 1995. As regards quantitative restrictions on imports, it is expected that they will be eliminated at the end of 2005, except for those that are maintained for health or security reasons. Despite the fact that Egypt's commitments substantially exceed the developing countries' average in terms of bindings and the gap between bound rates and applied rates, the UR Agreement will have a limited impact on trade liberalization in Egypt (Hoekman and Subramanian 1996).

On the other hand, what market access does the UR Agreement offer Egypt? In term of markets for Egyptian agricultural exports, the Agricultural Trade Liberalization Agreement in the UR Agreement represents one step forward and one backward. The tariffication and binding of all agricultural products is undoubtedly a step forward. But many of the newly established tariffs are so high in some countries that they effectively constrain trade. Binding tariffs to the base period of 1986 to 1988, when border protection was at a high point, diminishes liberalization. This is worsened in some cases by tariffication, since the new base tariffs offer even greater protection than the nontariff barriers they replaced. The magnitude of extensive tariffication varied among countries and commodities. Among the industrial countries, tariffication was most extensive in the European Union. Only Japan offered base tariff equivalents significantly lower than the nominal protection in the base year except on rice. In addition, the high levels of bound tariffs fails to stabilize tariffs and improve market access by allowing countries to apply variable tariffs. Also, the UR Agreement did not address issues such as import subsidies, export taxes and other domestic support measures (Ingco 1995).

If this is the case for agricultural products, what is awaiting Egypt's industrial exports? The proportion of industrial country tariffs on manufactured goods subject to bindings rose from 94 to 99 percent under the UR Agreement. About 18 percent of these countries' imports were already bound as duty-free tariff, reductions were

applied to 64 percent of imports and the remaining 18 percent were divided between bindings without reductions and no offers. In industrialized countries, the average tariff reduction on manufactured imports from developing countries is 30 percent, compared to 45 percent on imports from other industrial countries. This could have given Egypt a significant boost in market access, but the textile, clothing and footwear sectors, which have the highest tariffs, experienced lower price reductions than many other sectors. These two labor-intensive sectors are considered sensitive and accordingly receive below-average tariff reductions. On one hand, it is often said that the phasing out of quotas and the multi-fiber agreement (MFA) compensates for this; but on the other hand, there is increased competition. In addition, the remaining tariff escalation in industrial markets is a concern to developing countries including Egypt. As regards the industrial products in developing countries, only 60 percent of the tariffs are subject to bindings. Only 1 percent of their manufactured imports were initially bound as duty free, 32 percent bindings with tariff reductions, 26 percent bindings without reductions, and for the remaining 42 percent no offers were made (World Bank 1995b).

The ultimate impact of the UR Agreement on Egypt's exports will be the outcome of three market-access effects. These effects arise from Most Favored Nation (MFN) tariff cuts (a positive effect), the loss of preferential treatment due to MFN tariff cuts (a negative effect), and finally from liberalization of the MFA (a positive effect). Hoekman et al. (1996) estimated the impact these three effects on Egypt's non-oil exports to the European Union, the United States and Japan. They concluded that the most significant impact would stem from the liberalization of textile and clothing quotas. The impacts of the other two effects are marginal and almost outweigh one another. These results should be taken with caution, since the estimation procedure does not take into consideration the impact of the expected increase of competition in textile and clothing due to the phasing out of the MFA. Egypt must reduce costs and increase efficiency to remain a viable exporter.

Regional and Bilateral Liberalization

Egypt's regional and bilateral trade agreements include the free trade agreements (FTAs) with the European Union, the United States and some Arab countries, in addition to the Arab Free Trade Area (AFTA) and the Common Market for Eastern and Southern Africa (COMESA). It is worth noting that membership in a FTA is neither a necessary nor a sufficient condition for more liberal trade, according to

empirical evidence.¹² It is a country's general acceptance of a liberal trade policy that can make the difference (Foroutan 1998).

An FTA with the European Union

Egypt currently has preferential access to EU markets through the EU Generalized System of Preferences (GSP) and through the bilateral cooperation agreement of 1977. The latter grants Egypt duty-free access to the EU markets for industrial goods with some exceptions. A total of 32 textile products are excluded from duty-free entry into the EU.¹³ Moreover, textiles and clothing imported from Egypt have been subject to anti-dumping regulations by the EU. The cooperation agreement also grants Egypt preferential access for agricultural goods. Processed agricultural products imported from Egypt are exempted from the ad valorem tariff the EU imposes on the industrial component but are subject to levies on their agricultural component. As for Egypt, it continues to impose tariffs on goods imported from the EU (Hoekman and Djankov 1997). In general, exporters in Egypt rely more on the bilateral cooperation agreement than on the GSP. Products not covered by the GSP or the cooperation agreement are subject to the regulations of the WTO.

Egypt is currently negotiating an FTA with the EU as part of the new EU Mediterranean Strategy outlined in the 1995 Barcelona Declaration.¹⁴ Implementation of the new strategy requires signing bilateral agreements with the Southern Mediterranean countries with the objective of creating free trade areas within a period of 12 to 15 years and providing performance-linked financial assistance, among other requirements (Nsouli et al. 1996). The association agreements that the EU has signed with other countries suggest that the EU agreement with Egypt will aim at achieving reciprocal free trade of most manufactured goods and will grant reciprocal preferential access for agricultural products.¹⁵

The Egypt-EU negotiations have been underway for more than three years mainly because of the debate over agricultural and processed agricultural products. A number

¹² Chile, Korea, Mexico, Turkey, Argentina, Brazil, Peru, Uruguay, and Venezuela are examples of countries that have undertaken important liberalization steps before effectively joining any trade agreement; whereas, the trade regime of the countries engaged in the Central American Common Market (CACM) and the Andean Pact remained highly protective for years after their establishment.

¹³ Among these products are: woven cotton fabrics, knitted or crocheted fabrics, tulle lace embroidery, ribbons, traveling rugs and blankets, made-up articles wholly or chiefly of textile materials, articles of apparel and textile fabrics, and clothing accessories of textile fabrics.

¹⁴ The negotiations started in January 1995.

of key issues—oranges, rice and potatoes—have been problematic. Egypt insists on acquiring the best market access for these three products, which it has a comparative advantage producing and which represent 61 percent of Egypt's aggregate vegetable product exports and more than five percent of Egypt's total exports. The levies the EU imposes on the agricultural component of processed food imports from Egypt have also been a point of conflict. The EU insists on an agricultural agreement that complies with its well-known Common Agricultural Policy (CAP) which provides for limits on production, a high level of external protection and high support prices.

Critics maintain that the CAP could be an obstacle to Egypt achieving full market access for its agricultural products. Evidence for this is the UR Agreement on Agriculture. Negotiations for this agreement lasted for seven years because the EU insisted on ensuring the agreement's compatibility with the CAP. One of the reports by the EU shows the difficulties the Egyptian negotiators face: "The results of the UR give the EU enough room to maneuver to manage its own internal policies. Its market access commitments do not infringe on the principle of community preference and new possibilities have been opened up to European exporters.¹⁶ Its export commitments are compatible with the 1992 CAP reform and the peace clause puts the EU out of danger of any attacks that non-EU countries may make on its agricultural policies."¹⁷ (Directorate-General for Agriculture 1995). This indicates that Egypt and other Mediterranean countries should not have high expectations for the agreement; particularly because the EU considers Egypt's requests unrealistic based on agreements with the other countries, which trade more with the EU.

Nevertheless, the association agreement will be an important step towards trade liberalization, particularly because the EU is Egypt's major trading partner. The agreement with the EU also encourages liberalizing trade with third parties. For example, if Egypt enters into trade agreements with the other Mediterranean countries, it could benefit from the cumulation of origin allowed for in the agreements already signed with Tunisia and Morocco. An FTA with the EU, however, will not offer increased market access unless it improves the access of Egyptian agricultural exports to the EU

¹⁵ The EU already signed association agreements of this nature with Morocco, Tunisia, Israel, Jordan, and the Palestinian National Authority and is negotiating similar agreements with the Gulf States that should be completed by 1998. Negotiations with Syria, Algeria and Lebanon have already started.

¹⁶ The principle of *community preference* means that preference is given to goods produced inside the community. This principle entails keeping the prices of the community below those of imports to the European market. This led to the institution of two basic mechanisms of the CAP: import levies and export refunds (subsidies for exported community products to make them more competitive on world markets).

¹⁷ The peace clause means that the CAP instruments will not be contested as long as the disciplines resulting from the UR Agreement in the following three areas are fully observed: domestic support, export subsidies and market access.

markets. If the agreement is not signed Egypt's access to the EU market will worsen given that the cooperation agreement of 1977 will not be renewed and Egyptian exports will consequently face MFN tariff rates on the EU markets.

An FTA with the United States

Egypt has preferential access to the US markets through the American GSP regime that offers duty-free access to 3,666 tariff lines—about one-third of all US tariff lines. Nearly 88 percent of the GSP applies to industrial products: two-thirds relate to machinery and mechanical appliances, chemical products, basic metals, and optical, photography and cinematography products; 2 percent covers textiles and textile products to the United States, the remaining 10 percent applies to agricultural products. Tariffs on other exports are set according to WTO regulations. Under the GSP regime, Egypt exported a total of \$41.4 million in 1996, about 6 percent of Egypt's total exports to the United States that year. Egypt, in return, grants MFN status to imports from the United States according to its WTO obligations. Compared to the EU system of preferences, the American GSP is less favorable. The EU system is more reliable because of its contractual nature and because it provides Egypt with better market access since the coverage of the American GSP is more limited.

Egypt and the United States agreed in May 1998 to begin talks on a Trade and Investment Framework Agreement (TIFA) (U.S. Embassy in Cairo 1998). The TIFA is typically a forum for discussing and monitoring trade and investment issues, identifying impediments to trade and investment and working to remove these impediments. A TIFA is not a binding mechanism for resolving disputes. The TIFA is expected to be an intermediary step before beginning talks for a free trade area agreement at some time in the future.

When political and economic conditions are suitable to initiate an Egypt-US free trade agreement, the agreement will likely be finalized more quickly than the Egypt-EU negotiations. This is mainly because the United States agricultural sector is not as vulnerable as that of the EU with its CAP policy. Also, the prospects are better for offering Egypt more market access, if the NAFTA Agreement between the United States and Mexico is taken as a model for an agreement with Egypt. In addition to liberalizing trade in industrial products, NAFTA also managed to achieve this full liberalization in the agricultural sector (Office of the U.S. Trade Representative 1997). Table 6 shows the impact of the NAFTA on tariffs in Mexico and the United States.

Given the relatively high tariffs applied in Egypt and the importance of the United States as a trading partner to Egypt, an FTA with the United States will entail a significant reduction of Egypt's average nominal protection. By eliminating all tariff and nontariff barriers on Egyptian exports to the United States, this FTA will increase access to US markets. This is the case because in the absence of an FTA, the Egyptian

exports will continue to face tariff barriers on the US markets even after the full implementation of the UR Agreement, which commits the United States to reducing the trade-weighted average tariff on textiles from 17 percent to 15 percent. For specific textile imports, such as clothing, woven cotton fabrics and textile yarn and thread, the US tariff will be 11 percent, 19 percent and 8.57 percent, respectively after the UR Agreement. Also, important Egyptian agricultural exports, such as fresh vegetables, will continue to be subject to tariffs equal to 9.05 percent.

Table 6. Tariff Reductions in Mexico and the United States Due to NAFTA

Product Groupings	Mexico		United States		End of Transition Period
	1992	1996	1992	1996	
Animals and products	6.5	4.4	0.7	0	Phasing out tariffs and the immediate or phased elimination of important nontariff barriers
Vegetable products*	4.1	1.7	5.6	2.8	
Waxes, fats and oil	12.0	8.3	2.5	1.0	
Food, beverages and tobacco	15.2	9.6	3.6	2.2	
Mineral products	3.3	1.7	0.5	0	
Chemicals and related products	10.2	4.0	1.0	0.5	
Plastics, rubber and related products	13.9	8.2	1.1	0.2	
Leather, travel foods, etc.	8.8	5.1	5.5	1.7	
Wood and related articles	14.4	5.0	0.3	0.1	
Pulp, paper and related products	8.4	3.6	0.6	0.1	
Textiles and apparel**	16.0	5.3	9.1	1.3	
Shoes, headgear and related products	18.8	0.6	7.8	4.1	
Ceramics, glass and related products	16.0	6.2	4.3	2.6	
Jewelry, precious metals and stones	5.4	1.9	0.1	0	
Base metals and articles	12.4	6.7	2.0	1.3	
Electronic goods and appliances	13.4	4.4	2.6	0.4	
Transport equipment	15.1	4.9	1.6	0.6	
Scientific and other instruments	12.9	1.5	2.9	0.4	
Arms/ammunition	14.7	0	0.2	0	
Art and antiques	14.5	0	0	0	

* NAFTA eliminated all nontariff barriers and will eliminate all tariffs by the year 2008.

** Tariffs will be phased out in 10 years for products that meet rules of origin requirements. Import quotas in the United States will be lifted immediately for originating goods. Barriers covering 80 percent of textiles and apparel trade between the United States and Mexico will be eliminated in six years or less.

Sources: Office of the U.S. Trade Representative (1997), *Operation and Effect of the North American Free Trade Agreement*; U.S. Dept. of Commerce, Office of Textiles and Apparel; *Sector Summary for Textiles and Apparel in NAFTA*.

AFTA and Egypt-Arab Bilateral FTAs

The AFTA was launched on January 1, 1998. According to this agreement, an Arab free trade area will begin after 10 years, which means that tariff barriers will be eliminated within these 10 years. Tariff reductions already began in January 1998 with a 10 percent reduction on tariffs, taxes and duties with similar effects (Fawzy 1998a). As regards NTBs, a common list of goods prohibited for health, security and religious reasons has been prepared. The elimination of the remaining NTBs will be negotiated with the concerned committee. In case some members do not remove unjustified NTBs, the other members can apply the principle of reciprocity. Each country is allowed to draw a list of manufactured goods to be exempted from tariff and nontariff reductions, so that local industries can restructure to withstand competition (Zarrouk 1998). Finally, the agreement allows agricultural products, during the harvest season, to be outside tariff reduction throughout the transition period. Each country is allowed to include a maximum of 10 products exempted during harvest provided that exemptions do not exceed a total duration of more than 45 months. As of November 1998, almost a year from launching AFTA, only 14 of 18 Arab countries signing the AFTA had begun implementation—Egypt being one of them.

Besides joining the AFTA, Egypt has been involved in bilateral trade agreements with a number of Arab countries.¹⁸ The Arab League and the AFTA encourage other agreements that allow Arab countries to unilaterally, bilaterally or multilaterally establish free trade areas as a step towards a comprehensive AFTA to be signed in 2008. The agreements Egypt has signed so far, or is currently negotiating, aim at establishing free trade areas, usually for a period of five years, as a more rapid approach to liberalizing intra-Arab trade, compared to the longer-term AFTA.

AFTA and the Arab bilateral agreements are important in their own right, because they can reduce the ‘hub-and-spokes effect’ likely with the EU-Mediterranean agreements. They can also enhance border trade in bulky and short-lived goods and encourage Arab joint ventures. It is expected, however, that the AFTA will have limited impact on trade liberalization in Egypt. First, Egypt’s trade with Arab states

constitutes only a small portion of its total trade. Second, Egypt already exchanges goods at zero tariff with seven Arab countries and offers others preferential tariff treatment (*Al Ahram Newspaper*, 28 April 1998). The impact on Egypt’s market access will depend on the readiness of Arab countries to abandon the restrictive NTBs they impose on imports of agricultural products other imports, as well as on their ability to overcome the existing institutional and infrastructural constraints that could significantly limit trading opportunities among them.

¹⁸ Egypt has already signed free trade agreements with Jordan (1996), Tunisia (1997) and Morocco (1998) and is in the process of negotiating trade agreements with Lebanon, Kuwait, Syria, Yemen,

COMESA

Egypt joined COMESA in June 1998 (US Embassy in Cairo, July 1998). This trade agreement establishes free trade between its 21 signatory countries by the year 2000. By 2004, these countries will introduce a common external tariff (CET) structure to deal with third parties.¹⁹ The member countries agreed that the CET on capital goods will be zero and 5 percent on raw materials, 15 percent on intermediate goods, and 30 percent on final goods.

In 1996, Egypt's imports under COMESA constituted only 0.1 percent of its total imports, and exports to COMESA countries were only 0.8 percent of all Egyptian exports. Accordingly, COMESA will have only a limited impact on trade liberalization in Egypt. The most recent average tariff available to some COMESA countries indicates that the duty-free entry of Egyptian exports into this African market could significantly increase its market access.²⁰

To conclude, if Egypt enters into FTAs with the United States and the European Union, Egypt will enjoy a significantly more liberal trade regime in the 15 years from the signing date; however, this is not the whole story. Egypt faces major challenges to survive in this global environment and must withstand fierce competition in international and domestic markets. These challenges are discussed in detail in the next section.

V. Future Challenges

Export prospects are a major concern for Egypt given the new international trade environment, which is becoming more liberal over time. The outcome of Egypt's trade liberalization will depend on the country's ability to compete in global markets. In the EU markets, for example, Egypt will face aggressive competition from the Central and Eastern European Countries that share Egypt's advantage of relatively cheap labor and geographical proximity to the EU. In the US market, there are the NAFTA member countries that also pose a competitive threat. To face this challenge, Egypt must be more engaged in subcontracting activities with its major trading partners, maintaining a responsive exchange rate and improving the long-term indicators of competitiveness.

Bahrain, and Saudi Arabia. Egypt has also signed economic cooperation agreements with Libya that may lead to eventual negotiations for free trade area between them.

¹⁹ These countries are: Angola, Burundi, Comoros, Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe.

²⁰ The tariff rates for some COMESA countries are: Burundi 37 percent, Ethiopia 28.8 percent, Kenya 19.9 percent, Malawi 21 percent, Mauritius 29 percent, Rwanda 42 percent, Sudan 50 percent, Tanzania 27.5 percent, Uganda 17.1 percent, and Zimbabwe 21.8 percent.

First, Egypt needs to be engaged to a much larger extent in subcontracting activities with the European Union and the United States if it is to compete in today's global trading. Possible industries for cooperation are leather, garments, machinery, and furniture. The experiences of Central and Eastern Europe and Mexico with subcontracting have proven subcontracting to be a sound method for reducing the risks and costs of developing export markets while increasing exports. Subcontracting increased Central and Eastern European exports to the EU by 26 percent between 1989 and 1993 (Hoekman 1995). Since NAFTA began in 1994, Mexico's exports to the United States have more than tripled (US International Trade Commission 1998). The increased imports of apparel from Mexico are primarily due to NAFTA provisions that enable duty-free and quota-free entry for apparel assembled wholly from fabrics that are formed and cut in the United States. Two-thirds of Mexico's textiles and apparel exports to the United States are currently manufactured using US components, up from 42 percent in 1990.

Second, Egypt needs to maintain a responsive exchange rate. With the opening of the Egyptian economy, Egypt's imports are expected to rise, thus imposing pressures on the Egyptian pound, which is likely to appreciate. Furthermore, the significant currency devaluation in some Asian countries vis-à-vis the dollar, a factor in the recent Asian financial crisis, puts additional pressure on the Egyptian pound.²¹ The enhanced competitiveness in these countries could affect Egypt's export prospects. Maintaining a responsive exchange rate is also important because a steep real appreciation that undermines the current account generates expectations of re-imposed trade controls. Also, a widely fluctuating real exchange rate implies uncertain profitability in many sectors. These two factors hamper the reallocation of resources towards more productive sectors.

²¹ Between January 1997 and January 1998, the nominal depreciation in the five most affected Asian countries (Korea, Malaysia, Thailand, Indonesia, and the Philippines) ranged between 40 percent and 75 percent, and the real effective exchange rate depreciation ranged from 17 percent to 70 percent.

Third, Egypt must acquire the long-run determinants of competitiveness. These include obtaining and using technology, developing human capital, promoting investment, making the institutions that influence trade efficient, and ensuring the overall efficiency of economic activity and reliable infrastructure (Rajapatirana 1997). Egypt has made significant progress in macroeconomic and structural reforms; yet, more efforts are still required (Galal and Tohamy 1998). Structural reforms are an essential part of a more comprehensive reform agenda. A comprehensive reform agenda that extends beyond trade policies would help further Egypt's trade agenda and achieve the desired diversification that relies on the private sector initiative. Reform of labor markets, domestic regulation and capital markets would allow adjustment to changes in world markets thus preventing the build up of opposition to liberalization.

Negotiating more than one FTA at a time is an additional challenge Egypt faces. Each FTA will have its own set of rules of origin that govern the duty-free entry of goods into the member countries. The Egyptian negotiating teams should coordinate to ensure that the various rules are consistent. Numerous sets of rules of origin will be an administrative complication and will cause confusion between exporters—virtually a new trade barrier.

For Egypt, the fear of the trade diversion due to FTAs is minimal, yet there remains the hub-and-spokes effect resulting from agreements with the European Union and the United States.²² As the EU is likely to expand before 2010 to include several countries from Central and Eastern Europe, the hub will become even bigger. Egypt, therefore, needs to be engaged simultaneously in FTAs with other Mediterranean countries, and Arab-Arab trade liberalization now has an additional incentive.

VI. Concluding Remarks

Over the past two decades, Egypt's trade regime has become more liberal as indicated by the decline in the average tariff; dispersion of tariff rates, trade taxes and duties; reduced production coverage of NTBs; and finally by the unification and devaluation of the Egyptian pound. Yet indicators show that Egypt has consistently become less open than the fast-growing economies, over the period of the study, and has grown

²² This is because Egypt will be engaged in these agreements with its major trading partners. The European Union, the United States and Arab countries together account for 76 percent of Egypt's

less open and less integrated with the global economy over time. Egypt's comparatively low trade profile can be attributed to the overall business environment, public sector dominance of economic activity and relatively high tariff barriers. One possible reason for Egypt's turn inward is the importance of oil in the country's trade and the volatility of its price. High oil prices contributed to raising trade relative to GDP in the 1970s and early 1980s. In addition, falling prices in the mid-80s negatively affected this measure of openness. Another possible reason for Egypt's decreasing openness is the windfall gains to the economy from the oil revenues and others that raised the prices of nontradables versus tradables and thus attracted investment away from tradable sectors. Economic reform can be considered a third reason, as it was accompanied in its early stages with import suppression.

Egypt's efforts to liberalize trade through different trade agreements must be reinforced with a strong conviction in the benefits of free trade. To maximize possible benefits from these agreements, Egypt should complement its eagerness to reach the best agreement terms by developing its ability to compete in the different markets. This is crucial considering that Egypt has had excellent access to the EU markets for the past 20 years but was unable to penetrate the markets sufficiently and continues to loose ground.

A key element in increasing exports should be subcontracting as in the case of the Central and Eastern European countries to the European Union, and Mexico to the United States. Other challenges include encouraging the role of the private sector, facilitating domestic and foreign investment and maintaining a responsive exchange rate. Competitiveness, Egypt's ultimate aim, is best achieved through a comprehensive reform agenda. Long-term determinants of competitiveness will include technology acquisition, openness to investment, human capital development, and efficient institutions that govern the economic activity in Egypt.

As Egypt plans to enter into a number of free trade agreements, each with its own rules of origin, it is necessary to guarantee the consistency of these rules across different agreements. Anything other than a unified rules of origin will leave importers, exporters and government administration in a state of confusion thus adding yet another barrier to trade with Egypt.

exports and 69 percent of Egypt's imports. To minimize the diversion effect, Egypt should work to lower its MFN tariffs.

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