Towards an Egypt-US Free Trade Agreement:
An Egyptian Perspective

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Abstract

This paper examines an Egypt-US FTA from Egyptian perspective. It explores the choices facing negotiators and the probable implications of the most likely FTA scenario for Egypt. It considers three broad choices: a US-Israeli-style FTA focusing on the elimination of tariffs and restrictions; a broader agreement like the North-American Free Trade Agreement (NAFTA) which entails standardizing domestic competition policies and regulatory institutions; or a mix of both. The authors argue that a mix is probable and desirable from an Egyptian perspective. It avoids adapting US environmental and labor standard policies, since they may not be appropriate for Egypt at its current level of development. It would also give Egypt access to US markets (especially for textile and agricultural products), increase FDI, and would improve how the country's policy reform is viewed internationally.

ملخص

تحلل هذه الورقة اتفاق منطقة التجارة الحرة بين مصر والولايات المتحدة من المنظور المصرى حيث تقدم صوراً بديلة للاتفاقية والآثار المترتبة عليها. ويعرض البحث ثلاثة صور أو نماذج للاتفاقية للاختيار بينهما: الأول اتفاق تقليدى للتجارة الحرة (مثل الاتفاق الأمريكى الاسرائيلى) يركز على إلغاء الرسوم الجمركية والقيود الكمية بين طرفيه. والثانى: اتفاق أكثر عمقاً على غرار اتفاق التجارة الحرة بين دول أمريكا الشمالية (النافتا) الذى يمتد ليشمل تنسيق المنافسة والمؤسسات التنظيمية، والثالث: مزيجاً من الاختياريين السابقين. ويؤكد الباحثان أن الاختيار الثالث هو المتوقع والأفضل بالنسبة لمصر، إذ أنه لا يتضمن فرض سياسات تنظيمية وتشريعية متشددة فى مجال قوانين العمل والحفاظ على البيئة التى قد لا تتناسب مع ظروف مصر الحالية. كما يضمن الاختيار الثالث نفاذ الصادرات المصرية إلى السوق الأمريكية (خاصة المنسوجات والمنتجات الزراعية) ويساعد على زيادة الاستثمارات الأمريكية فى مصر، وأخيراً يؤكد دولياً التزام مصر بسياسة الإصلاح الاقتصادى.

1. Introduction

There is increasing evidence to support the premise that openness is key to economic growth.[1] This finding is being translated into actions the world over, from Latin America to the Far East. Simultaneously, both developed and developing countries are increasingly forming regional trading blocks, the most familiar being the European Union (EU), North America Free Trade Agreement (NAFTA), ASEAN Free Trade Agreement (AFTA), and Mercusor (of South America). Regional trading blocks have been pursued to secure market access, attract international capital, and anchor policy reforms.

Like other countries, Egypt has been moving on both fronts. Since the early 1990s, significant steps have been taken to liberalize the trade regime, including exchange rate unification and devaluation, removal of quantitative restrictions, and lowering of tariff barriers. On the regional front, Egypt is about to conclude a free trade agreement (FTA) with the European Union. At the same time, major efforts are underway to revive the establishment of a FTA with Arab countries. And, in their April 1997 meeting, President Mubarak and Vice President Al Gore agreed to explore the possibility of a FTA between Egypt and the United States. This Egypt-US initiative is the focus of this paper.

As the Egyptian and American teams meet to discuss a FTA between the two countries, several questions will likely be on their minds. Among them: What will each party gain? What are the terms that will benefit both parties? How will each of them reconcile the agreement with other international commitments? This paper is intended to contribute to this discussion from an Egyptian perspective.[2] The analysis has positive and normative components. On the positive side, it seeks to characterize the nature of the relationship between Egypt and the United States, identify the factors influencing this relationship, and make predictions about its evolution. On the normative side, it seeks to outline the options for Egyptian policy makers, so as to maximize the gains from a FTA with the United States.

In conducting the analysis, the paper takes as given a number of features that seem to distinguish the economic relationship between Egypt and the United States. First,

[1] See, for example, Barro, 1991; Krueger, 1997; and Sachs and Warner, 1995

[2] Two companion papers deal with the US perspective (Lawrence, 1997b) and the estimation of the welfare implications of the Agreement on Egypt (Hoekman, Konan and Maskus, 1997).

this relationship is not determined on economic grounds alone. Political factors play an important role, as evidenced by the magnitude of US aid to Egypt ($2.3 billion annually). Second, there is growing recognition on both sides that the case for continued economic aid may diminish in the future. Egypt will nevertheless continue to gain US support because of its peace promoting role in the region and its dedication to maintaining a stable Middle East. Both are important in their own right and essential for the secure flow of oil from the region. Finally, whether or not aid to Egypt diminishes in the future, the emphasis on trade and investment must be viewed in the United States and Egypt as beneficial to both parties, otherwise opposition will mount to its detriment.

Section 2 analyzes current Egypt-US economic relations and outlines the broad choices facing negotiators as they discuss a FTA between the two countries. Section 3 explores the potential benefits to Egypt by analyzing the possible terms of an agreement. Section 4 discusses the potential benefits to Egypt as a result of the economy's readiness to respond to the agreement. Section 5 provides concluding remarks.

2. Egypt-US Economic Relationship and Broad FTA Choices

A natural place to start a discussion about a FTA between Egypt and the United States is to consider two questions. First, what is the current nature of the Egypt-US relationship? This provides a benchmark against which the benefits from a FTA can be assessed. Second, what kind of a FTA should the two parties seek? Should the agreement resemble the US-Israeli FTA, NAFTA, or something else?

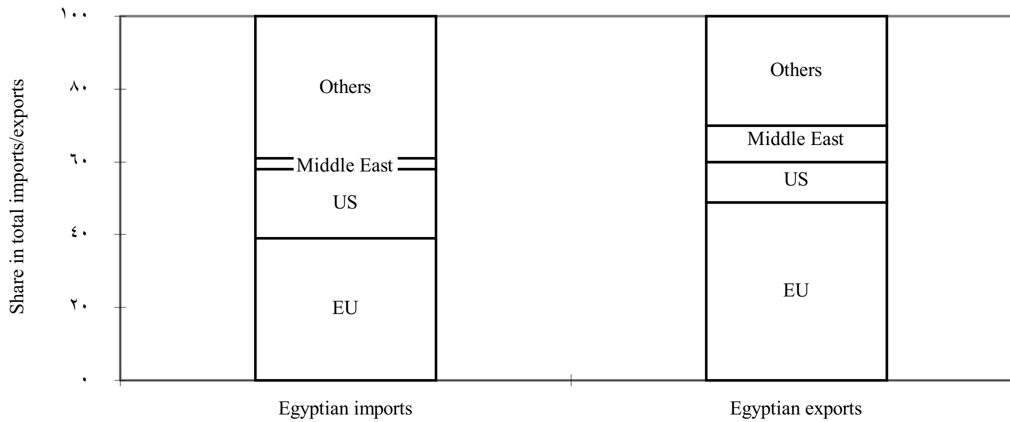
Egypt-US Economic Relationship

The economic relationship between Egypt and the United States is important to both countries, although more so for Egypt given the relative size of the two economies. The current relationship encompasses trade in goods and services, capital inflows and significant transfer of aid. However, this relationship is undiversified with a significant trade deficit in favor of the United States, low-level and excessive concentration of US investment in Egypt in the oil sector, and domination of aid relative to trade and investment.

Trade

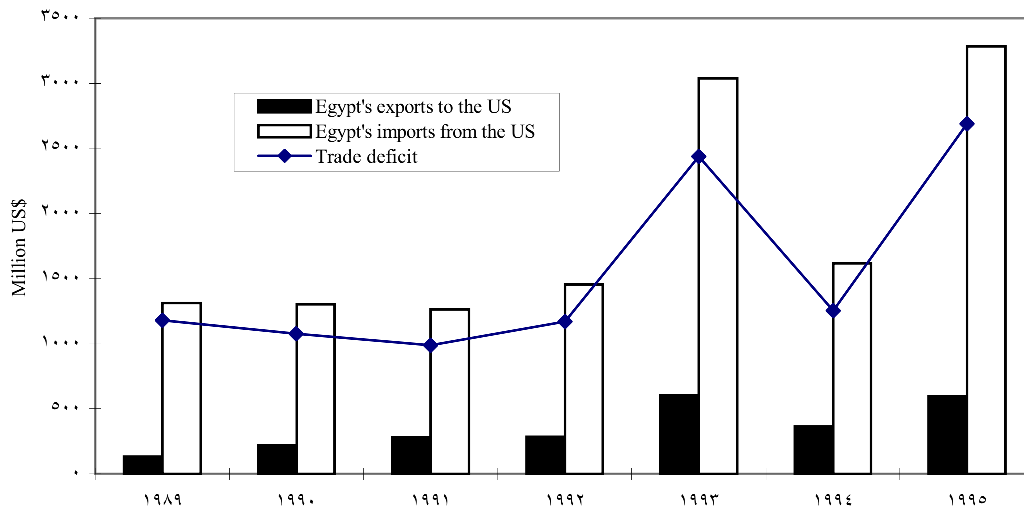
The United States is Egypt's second major trading partner in imports. Almost one-fifth of Egypt's imports come from the United States, which is only exceeded by the European Union collectively (Figure 1). But Egypt's exports to the United States are more modest, amounting to less than one billion dollars a year, or about 10 percent of Egypt's total exports. Egyptian exports to the United States have been on the rise since 1989, but the trade deficit between the two countries has increased reaching $2.6 billion in 1995. The size of the deficit is insignificant to an economy as large as that of the United States, but it accounts for half of Egypt's total exports in the same year (Figure 2).

Figure ١. Egypt's Trade Pattern, ١٩٩٥



Source: IMF, Direction of Trade Statistics Yearbook, 1996

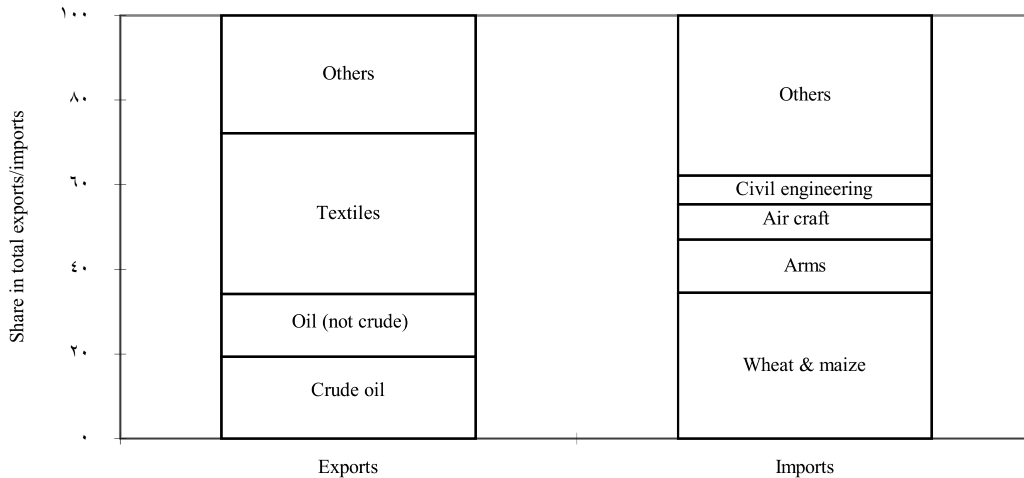
Figure ٢. Egypt-US Trade Balance, ١٩٨٩-١٩٩٥



Source: IMF, Direction of Trade Statistics Yearbook, 1996.

The composition of Egyptian exports and imports to and from the United States shows a high degree of concentration. Egypt imports wheat and maize from the United States, which accounted for 34.5 percent of total imports in 1996, while Egypt's arms and ammunition imports accounted for 13 percent in the same year. The remaining principal imports are aircraft, civil engineering and contractors' plant and equipment, paper and paper board, and telecommunications equipment, which account for 16 percent of the total. Given that some of these items are tied to US aid, a decline in aid would diminish US exports to Egypt. As for Egyptian exports to the United States, the main items are ready-made garments (38 percent of total exports) and other textile fabrics and accessories (12 percent also of total exports). Aside from textiles, mineral fuel oil and its distilled products accounted for 34 percent of total exports to the United States in 1996 (Figure 3).

Figure ٣. Composition of Egyptian Exports and Imports to the United States, ١٩٩٦

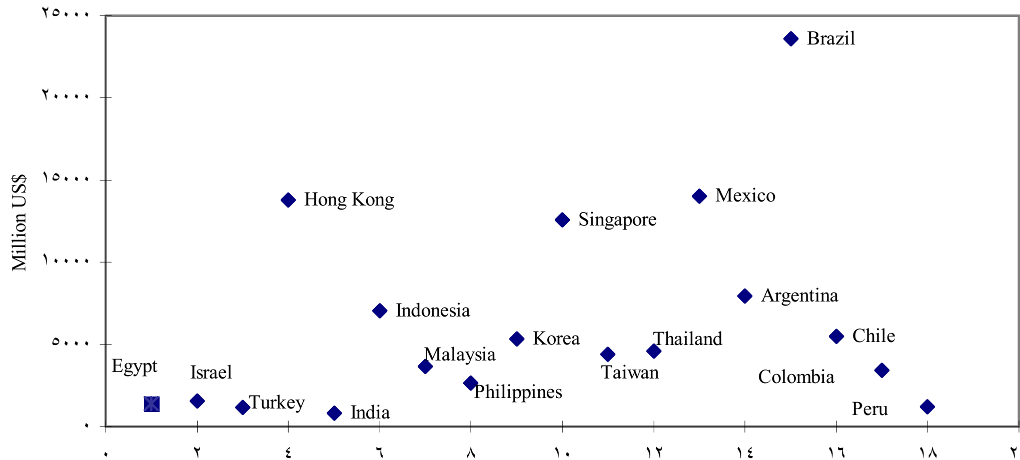


Source: Calculated from US Department of Commerce data.

Foreign Direct Investment

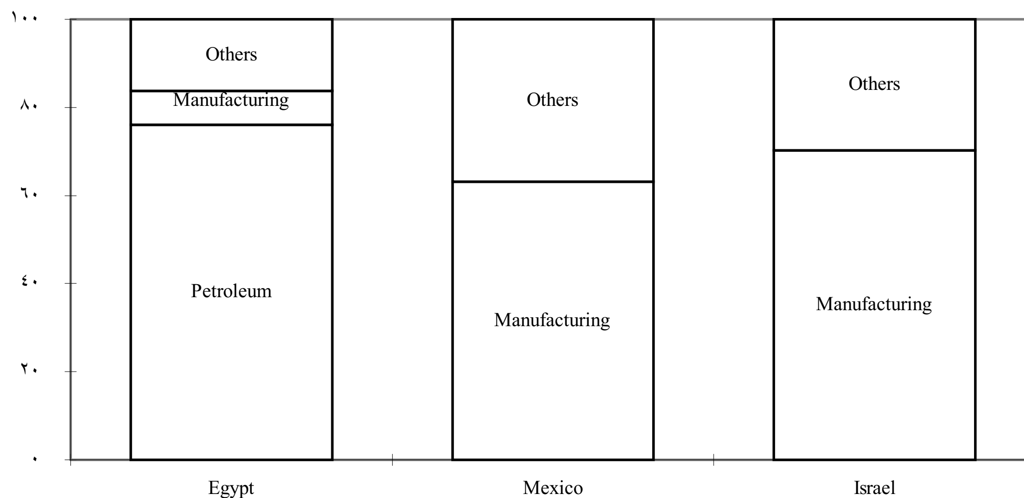
US investment in Egypt, end-of-1995 stock, was $1.41 billion. This level of investment is relatively modest compared with US foreign direct investment (FDI) in Latin America and East Asia. Brazil, for example, received as much as $23.6 billion in US FDI by 1994, and Mexico $14 billion (Figure 4).

Figure ٤. US FDI in Egypt and Selected Countries, ١٩٩٥



Source: US State Department, Country reports on Economic Policy and Trade Practices Reports, different years.

Figure ٥. Sectoral Distribution of US FDI in Egypt, Mexico, and Israel, ١٩٩٥



Source: US State Department, Country reports on Economic Policy and Trade Practices, 1996.

It is true that Egypt received about as much US FDI as Turkey (with a stock of US FDI of $1.17 billion by 1995) and Israel ($1.57 billion by 1995), but the bulk of US FDI (76 percent) to Egypt went to the oil sector and only 7.7 percent to manufacturing. In contrast, the manufacturing sector in Israel and Mexico received 70 percent and 61 percent of total US FDI, respectively (Figure 5).

The low level of US FDI in Egypt and its concentration in the oil sector may be attributed to the limited attraction of the Egyptian economy compared with alternative

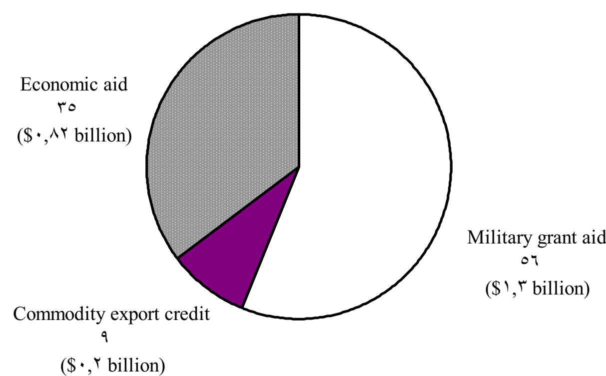
investment opportunities in the Far East and the emerging economies in Latin America. But the economic landscape in Egypt has changed significantly in the 1990s, making Egypt a more attractive market for FDI than in the past.

Aid

US aid to Egypt has been the most significant component of the economic relationship between the two countries since 1979. Over the past 7 years (1990-96), Egypt has received annually some $2.3 billion, second only to Israel as the largest recipient of American aid. Over the period 1990-96 alone, cumulative aid to Egypt was $15.76 billion, which represents 26 percent of Egypt's GDP in 1995. Most of the aid (56 percent in 1996) was earmarked for military expenditure. The rest was in the form of grants (35 percent), and commodity export credit guarantees, GSM 102 (9 percent) (Figure 6).

Aid funds undoubtedly contributed to relaxing the foreign exchange constraint facing the Egyptian economy. Funds earmarked for military expenditure also benefited the economy, since Egypt would have had to raise these funds, or a fraction of them, internally or externally. Moreover, aid has contributed to the expansion of infrastructure and helped to support policy and institutional reforms to encourage a more market-oriented and private sector-led economy. On the other hand, there are those who argue that aid may have provided policy makers with a cushion, which contributed to a delay of essential policy reforms. For example, Krueger (1997) argues that Korea only began its reform process in the early 1960s when the United States

Figure ٦. Components of US Aid to Egypt, ١٩٩٦



Source: US Embassy, Foreign Economic Trends and their Implications for the United States, various issues.

threatened to stop the flow of aid. There are others (Burnside and Dollar, 1997) who argue that aid displaces domestic savings by making more resources available for consumption.

Whatever the effect of aid on the Egyptian economy, the recent debate in the US Congress regarding aid to Egypt suggests that the future of US aid to Egypt is uncertain. Therefore, there is a need to explore alternative ways to continue the economic ties between Egypt and the United States. One alternative is a FTA, which is likely to succeed if it is designed to satisfy the interests of both parties. This depends in part on the nature of the agreement itself.

Broad Choices

Within the limits of international commitments and domestic politics of both the United States and Egypt, the terms of a FTA agreement are essentially endogenous to the negotiators on both sides. They can opt for what Lawrence (1997a) calls “shallow” or “deep” integration; they can choose to cover issues related to trade, services and investment, or a subset of these; they can follow the GATT provisions on harmonization of domestic regulatory policies, or go beyond. Whatever the negotiators decide determines the economic impact of the agreement for both parties. The question is: What kind of agreement are the negotiators *likely* to (and possibly *should*) seek? Three broad choices are relevant.

The first broad choice is a *classical free-trade agreement,* along the lines of the US-Israel FTA. This type of agreement focuses on the elimination of tariffs and quantitative restrictions among the parties concerned. It tends to ignore the harmonization of domestic competition policies and regulations that may influence investment and trade flows as much as border policies, if not more so. While they may be perceived as a step in the direction of multilateral liberalization, border-liberalization trade agreements represent “incomplete” efforts toward regional integration and efficient allocation of resources.

The economic effect of classical free-trade agreements, as Viner (1950) postulated, is to “create” trade between the partners of the agreement and hence increase the welfare of the nations involved. At the same time, they “divert” trade between the countries involved, on the one hand, and the rest of the world, on the other. The net effect can be positive or negative, but is generally limited in magnitude. Maskus and

Konan (1997), for example, estimate the gains to Egypt from trade liberalization with the European Union to be approximately 0.2 percent of GDP. In the case of Egypt, an agreement with the United States is likely to reduce trade diversion due to its agreement with the European Union, given the relative importance of the United States as a trading partner.

The second broad choice facing the negotiators is a *deep integration agreement***,** of the variety adopted in NAFTA. This type of agreement extends its liberalization focus to many aspects of the domestic economic environment affecting the production of goods, services and investment. It involves the harmonization of competition policies and regulatory institutions with respect to such policies as environmental standards, labor laws, government procurement, anti-trust legislation, and intellectual property rights. Agreements of this type represent the closest option to complete elimination of barriers to trade and capital flows. They characterize the most recent class of FTAs.

The merit of deep integration agreements is that they can generate both static and dynamic gains. Static gains follow from better allocation of resources in a more liberalized environment. Dynamic gains follow from greater investment, improved productivity and reduced transaction costs. To the extent that they also enhance investor confidence in the stability of policy reform, they reduce the perception of risk and encourage the flow of FDI. In turn, FDI can produce an immediate increase in labor productivity and a more long-term accumulation of technology and human capital.

"Deeper" integration does not always mean "better" integration. It is possible that the adoption of common standards may favor industries of one country at the expense of the other. It is also possible that forcing the regulatory policy of one country on the other may serve as an indirect trade barrier (Noll 1997). Finally, not all countries are at the same level of development, which means that immediate enforcement of the agreement may discriminate against the local industry of the poorer country and deprive its producers of the ability to adjust and take the necessary steps to compete against large, well-established multinational competitors.

Faced with the limitations of classical and deep free-trade agreements, the negotiators may opt for a combination of both. This hybrid can be termed an *eclectic free-trade agreement*. The fundamental character of this type of agreement is that it combines liberalization of trade barriers between the two parties and the

harmonization of *some* domestic competition policies and regulatory institutions. The choice of the domestic policies for negotiation and the ultimate agreement on harmonizing them must be determined on a case-by-case basis, in view of the extent to which domestic regulatory policies and institutions diverge among the parties involved and the political feasibility of bridging the gap.

Since this type of agreement cannot be well defined, its effect cannot be easily predicted. However, it is reasonable to expect that a well-designed eclectic FTA could be more beneficial than the other two types of agreements. This is because while it could generate the static and dynamic gains associated with deep integration agreements, it could also avoid the shortcomings of deep integration agreements associated with the imposition of inappropriate regulatory policies of one country on the other. Conversely, poorly designed eclectic FTAs could have the opposite effect. This conclusion raises questions regarding the key elements of a possible FTA between Egypt and the United States, and its repercussions.

3. Potential Benefits to Egypt of a FTA with the United States: Terms of the Agreement

What then are the likely terms of a FTA between Egypt and the United States? And, what are the likely repercussions of these terms? These two questions are addressed in this section, drawing on previous agreements to which either Egypt or the United States adhered (namely, the on-going Egypt-EU agreement, the 1985 Israel-US FTA, and NAFTA). The discussion revolves around the agreement's three major potential benefits for Egypt: market access, increased investment and policy reform anchor.

Market Access

The performance of Egypt's non-traditional exports has been less than satisfactory in recent years. During the period 1984-93, manufacturing exports grew at the modest rate of 1.0 percent (Sachs, 1996). This poor performance is attributed to several factors, one of which is market access. The question is therefore whether a FTA with the United States will increase the access of Egyptian exporters to the US market.

Increased access depends in part on the terms of the agreement. It is useful to note that both NAFTA and, to a lesser extent, the 1985 Israeli-US FTA contain articles that stipulate the elimination of non-tariff restrictions and the elimination or reduction of tariffs between partners. The two agreements also remove restrictions on other

complementary measures to the elimination of tariff and quantitative restrictions such as quality control, antidumping regulations and requirements for the purchase of local goods. A FTA with Egypt is likely to include similar conditions. But the effect of these provisions on access to US markets depends on whether Egyptian exporters will face high barriers to the US market and when these barriers will be removed.

In terms of trade barriers, the American economy is fairly open, with an average tariff rate of 5.9 percent according to the Most Favored Nation (MFN) schedule (Table 1). This suggests limited increased access to the US market, but this conclusion

Table 1. United States Most Favored Nation Tariffs in 1995 by 2-Digit ISIC

	Applied tariff in 1995			
	Min. tariff	Max. tariff	Average tariff	Number of non-ad. val.
Agriculture	**0**	**188**	**4.1**	**203**
Agriculture, hunting	0	188	5.4	194
Forestry, logging	0	10	1.0	3
Fishing	0	8	0.5	6
Manufacturing	**0**	**151**	**6.1**	**1193**
Food and beverages	0	151	8.7	541
Tobacco products				11
Textiles	0	35	10.5	62
Wearing apparel	0	34	12.9	79
Luggage and handbags	0	48	11.6	16
Wood and products of wood	0	18	3.8	12
Paper and paper products	0	15	2.0	2
Publishing and printing	0	7	1.7	10
Coke and refined petrol	0	7	1.7	9
Chemicals and chemical products	0	22	5.0	173
Robber and plastic products	0	15	4.4	1
Other non-metal mineral products	0	38	6.9	18
Basic metals	0	18	4.3	12
Fabricated metal products	0	16	4.3	57
Machines and equipment	0	13	3.0	5
Office machines	0	5	1.9	0
Electrical machines	0	23	4.1	0
Radio and TV equipment	0	15	4.7	0
Medical and precision instruments	0	19	5.0	152
Motor vehicles and trailers	0	25	3.1	0
Other transport equipment	0	18	4.2	0
Furniture, jewelry, toys	0	32	4.4	33
Overall	**0**	**188**	**5.9**	**1441**

Source: Inter-American Development Bank, Statistics and Quantitative Analysis, Integration and Regional Programs Department.

is misleading. Egyptian exporters face high tariffs on exports to the United States of important items such as textiles and agriculture products. Under the MFN tariff schedule, US textile imports face an average tariff of 10.5 percent, with the maximum tariff applied to this sector being 35 percent. In addition to tariffs, exports of textiles to the United States are subject to country quotas. Egypt faces quotas on 18 textile products, including cotton yarn, cloth, and various types of ready-made garments and clothing.

Given that the Uruguay Round only commits the United States to reducing its trade weighted average tariff on textiles from 17.2 percent to 15.2 percent over 10 years, Egyptian exporters will continue to face tariff barriers to the US market in the absence of a FTA (Table 2).

Table 2. Selected US Commitments Under the GATT

Agreement	U.S. Commitment
General Agreement for Tariffs and Trade (GATT)	• Eliminates tariffs in sectors such as construction, agricultural and medical equipment, steel, pharmaceuticals, paper, pulp and printed material, and furniture and toys. • Reduces trade-weighted tariff averages on industrial products by 35 percent. • Increases the number of ‘bound’ tariff lines to 100 percent. • Requires participation in a tariff harmonization initiative that reduces tariffs in the chemical sector to very low rates reaching zero in some cases.
Agreement on Agriculture*	• Replaces Non-Tariff Barriers (NTB) with tariffs. • Reduces new and existing tariffs by 36 percent on average over six years. • Curtails export subsidies in budgetary outlays by 36 percent. • Reduces domestic support to agricultural producers by 20 percent over 6 years.
Agreement on Textiles and Clothing	• Reduces tariffs on textiles and apparel from a 17.2 percent to 15.2 percent trade weighted ad valorem average over 10 years. • Increases the Multi-Fiber Arrangement quota growth rates in three successive stages over 10 years: 16 percent in 1995, an additional 25 percent in 1998 and an additional 27 percent in 2002.

* Agriculture includes food processing.

Source: GATT Secretariat (1994). *The Results of the Uruguay Round of Multilateral Trade Negotiations*. Office of Textile & Apparel, US Commerce Department (OTEXA).

In the agricultural sector, tariff rates on specific commodities are as high as 188 percent in addition to various non-ad-valorem duties.[٢] While Egypt does not face quotas on agricultural exports to the United States, the current MFN tariff schedule and the US commitments under the Uruguay Round do not eliminate tariffs on agricultural products. In fact, under the GATT the United States is committed to

[٢] Non-ad-valorem duties are custom duties that are specified in dollars or cents per unit of imported commodity and not in terms of its value.

reducing existing tariffs by 36 percent on average over a period of six years (Table 2). Accordingly, a FTA with the United States that includes immediate access for agricultural products of Egyptian origin will increase Egypt's exports. This will be consistent with the US agreement in the context of NAFTA, in which the agreement eliminates immediately all non-tariff barriers to agricultural trade, generally through their conversion to either "tariff-rate quotas" or ordinary tariffs. Above quota trade will be subject to the gradual reduction of tariffs. All tariff barriers between Mexico and the United States will be eliminated no later than 10 to 15 years after signing of NAFTA.[٤] If the United States agrees to similar terms with Egypt, this may prove to be particularly important given that the Egypt-EU proposed agreement does not include a substantial increase in access to the EU markets.

As for the timing, it is expected that Egypt will have essentially immediate access to the US market, while American firms will have delayed access to the Egyptian market. This parallels the treatment of Mexico in the context of NAFTA, in which the opening of US borders to most of Mexico's manufactures was implemented immediately, while the elimination of Mexican tariffs is phased over a period of 5 to 10 years. A similar asymmetric timetable characterizes the proposed Egypt-EU agreement. Additional provisions may also be adopted with respect to some "infant industries" by allowing new industries in Egypt to receive above-agreement protection for a specific period of time. "Infant industry" protection, however, is usually governed closely by the explicit terms of the agreement or by the supervisory body responsible for the administration of the terms of the agreement. Moreover, the parties are likely to agree on certain rules of origin to ensure that benefits of the agreement are accorded only to goods produced in the two countries. NAFTA, for example, specifies "yarn forward" rules of origin for textiles and that automotive goods must contain 60 percent and 62.5 percent of North American content.

While the FTA with the United States may increase access for Egyptian exporters, it may depend on more difficult negotiations on issues such as government procurement and domestic competition policy. In particular, the United States is likely to insist that Egypt eliminate the preferential access to government purchases given to Egyptian domestic suppliers (15 percent). The United States will also probably ask

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[٤] In the 1985 Israeli-US FTA, quantitative restrictions other than tariffs were maintained in each country to suit their general agricultural policy considerations.

Egypt to adopt anti-trust legislation to prevent any abuse of market power and harmful mergers and acquisitions. These two issues are now being considered unilaterally by the Egyptian government in its effort to make the economy more market-oriented.

How much more trade can Egypt expect by signing a FTA with the United States, assuming the agreements with the European Union and Arab countries are in force? Hoekman, Konan and Mascus (1997) estimate trade creation from a FTA with the United States at $342 million under a classical FTA and $450 million under a NAFTA-type agreement. They also estimate lower trade diversion under a NAFTA-type agreement ($170 million) than under a classical FTA ($197 million). Overall, they estimate that undertaking a FTA with the United States, in addition to FTAs with the European Union and Arab countries, will increase welfare in Egypt by 1.26 percent of GDP (if the FTA with the United States is a classical FTA) and 1.84 percent of GDP (if the agreement is a NAFTA-type).

Investment

Egypt is keen on attracting FDI for several reasons, including its desire to acquire new technology, management and marketing capabilities. FDI is perhaps more importantly needed to enable the country to grow much faster (7-8 percent) in order to create enough jobs for new entrants into the labor market (estimated at half a million a year) and to reduce the current unemployment rate of above 10 percent. This high-growth scenario requires that the ratio of investment to GDP increase to 25 to 27 percent, though national savings is only 18 percent. To the extent that the agreement will contribute to increased FDI in Egypt, the benefits to the economy could be substantial.

In this regard, negotiators have two approaches. The first is to limit their commitments to those already made under GATT and GATS, which is what Egypt has done in its negotiation of the EU FTA. Israel also took this approach in its FTA with the United States.[°] The second is the approach followed in NAFTA, which goes significantly beyond GATT and GATS. Under NAFTA, investment liberalization is pursued by granting investors of the other country the right of establishment, by eliminating performance requirements (for example, minimum exports, local contents, local presence for the provision of services), by removing restrictions on currency

[°] The 1985 Israeli-US agreement limits its coverage of trade in services to recommending that the parties minimize restrictions on the flow of services between the two nations and develop means for cooperating on this goal.

expatriation, by prohibiting expropriation of foreign investment, and by providing for fair compensation in case of expropriation. In the same agreement, Mexico also agreed to allow foreign investment in most sectors of its economy, except those which are constitutionally reserved for the state, such as social and maritime services.

From an Egyptian perspective, it may seem that no further commitments beyond the GATT are necessary under the FTA with the United States, because Egypt can pursue liberalization of investment and services unilaterally (as Mexico did with its telecommunications sector, and as Egypt is actually doing now). However, this may not be desirable because Egypt can improve foreign investors' perception of the credibility of its policy reform if it commits to an external binding with the United States.[٦] This approach may also not be feasible if the United States insists on applying the NAFTA model to any of its subsequent FTAs with other countries, including Egypt. Whatever framework is adopted, however, either of the parties may still put a number of FDI-related issues on the table. These issues include intellectual property rights (IPRs) and labor laws.

The FDI-related arguments in favor of protecting IPRs are straightforward: they encourage the flow of FDI to produce local commodities such as computer software and pharmaceuticals, and they encourage the domestic and foreign private sector to invest in R&D. In principle, this should not be a problem for Egypt, given that it is both a market for and a producer of products that IPRs can protect and for which they can increase production incentives. Moreover, Egypt's present law protects IPRs and provides national treatment for products of other countries (Subramanian and Abd-El-Latif 1997). These commitments were reiterated in Egypt's signing of the WTO Trade-Related Intellectual Property Rights agreement (TRIP).

The "catch," however, is that TRIP provides for a transition period, starting in 1995, during which pharmaceutical patents may be put in a "black box" for 10 years by countries which did not previously grant patent protection (including Egypt). A similar time frame is required to obtain approval for commercial marketing of patented products in developed countries. This means that both the positive and negative effects of TRIP on the Egyptian pharmaceutical industry will first be felt by the year 2005, given that Egypt made no further commitments in its EU agreement. In the context of a FTA with the United States, however, it is likely that Egypt will be

asked to agree to eliminate or shorten the 10-year transition period that TRIP allows. Debate over the issue of timing has been intense in Egypt, due to the concern about the negative impact this will have on the pharmaceutical industry and consumers as prices of pharmaceutical products increase. To the extent that these concerns are valid, a resolution to the conflict may involve estimating the potential cost involved and some form of financial compensation as in the Egypt-EU arrangement.

As for the interaction between labor laws and FDI, it is generally accepted that, all things equal, FDI will gravitate to countries where labor is both skilled and relatively inexpensive. Segmented labor markets, poor training programs, and inflexible wage policies act as deterrents to FDI. In Egypt, the market is somewhat segmented, with 35 percent of the labor force in the public sector and working with limited flexibility and few incentives to improve their skill level. Labor laws seem extremely rigid when it comes to hiring and firing. But the picture is not as grim as it appears. On the one hand, surveys of the business sector show that labor laws are not considered as binding as they may seem (Galal 1996). On the other hand, real wages have been declining during the period 1982/83 to 1992/93 (Radwan, forthcoming), which suggests that the market is more flexible than it seems. Finally, the Egyptian labor force is relatively skilled, as evidenced by the 10 to 15 percent of the labor force working in nearby countries.

While the US negotiators may raise concerns about workers' rights, the Egyptian side is likely to assert that their laws guarantee reasonable standards for health and safety, bans on child labor, and anti-discrimination measures. In the end, the two parties may agree to provisions similar to those included in NAFTA. The essence of these provisions is that no commitments are made beyond certain guiding principles, subject to each party's domestic law, without establishing common minimum standards. Thus, the agreement may indicate that parties will develop laws, regulations, procedures and practices in their own way that protect the rights and interests of their respective workforces. For example, minimum employment standards, the right to collective bargaining, and measures against discrimination would be included. As in NAFTA, the agreement may include procedures for complaints about violations of the agreement, and may even include financial penalties.

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[٦] See subsection 3.3.

How much will a FTA with the United States contribute to higher FDI in Egypt? This is a difficult question, especially because FDI depends on a host of factors. But if the experience of other countries is any guidance, the benefits can be substantial. The stock of US FDI in Mexico jumped from $9.4 billion in 1990 when NAFTA was first announced to about $19 billion in 1996.[٧] Thus, US FDI in Mexico more than doubled over a period of seven years.[٨] Mexico also attracted substantial investment from non-US sources, which combined with US investment to produce $24 billion worth of FDI over a period of five years, or the equivalent of 10 percent of Mexico's GDP in 1990[٩] (Table 3).

Similarly, Spain and Portugal received large FDI inflows following their accession to the European Union in 1985 (Figure 7). Spain's average annual FDI inflow increased from $1.68 billion in the five years prior to integration to an average of $5.09 billion in the five years following integration. The corresponding figures for Portugal are $0.16 billion for 1980-84 versus $0.73 for 1985-89. Over ten years the two countries attracted FDI that is equivalent to around half of their respective 1985 GDP (Table 3).

Table 3. Pre- and Post Agreement FDI Flows in Mexico, Portugal and Spain

	Mexico	Portugal	Spain
Average Annual FDI Flows			
Pre-agreement* (Bn USD)	0.8	0.16	1.68
Post-agreement** (Bn USD)	4.8	0.73	5.09
Cumulative FDI/ Base-year GDP* **			
5-year cumulative (%)	10	16.24	13.89
10 year cumulative (%)	N.A	59.58	45.16

* Pre-agreement averages are over years 1985-89 for Mexico and 1980-84 for Portugal and Spain.

** Post-agreement averages are over years 1990-94 for Mexico and 1985-89 for Portugal and Spain.

*** Base-year is 1990 for Mexico and 1985 for Portugal and Spain.

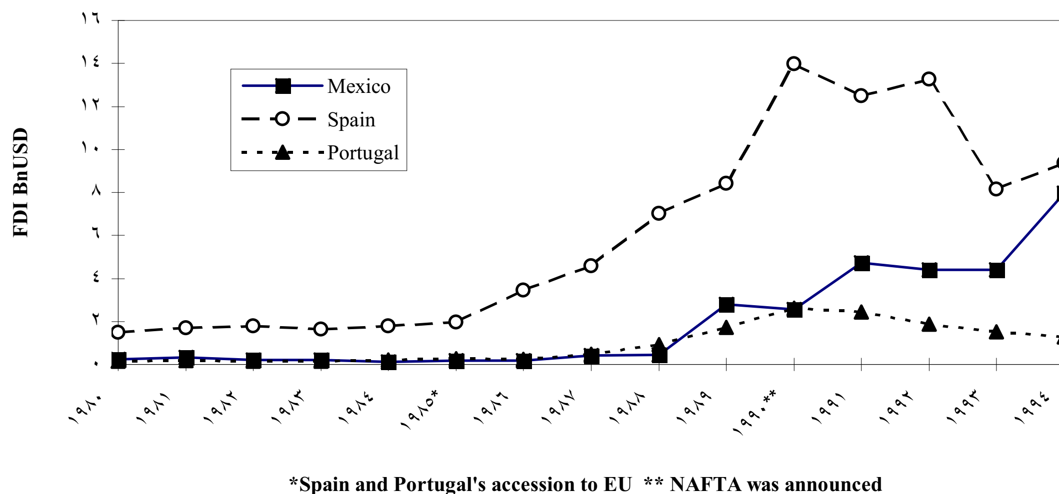
Source: International Financial Statistics, various issues.

[٧] Survey of current business, Bureau of Economic Analysis, various issues.

[٨] Calculated from International Financial Statistics capital accounts data and Survey of Current Business, various issues.

[٩] Kehoe (1996) argues that an important aspect of Mexico's liberalization is the removal of barriers to FDI.

Figure ٧. Annual FDI Flows in Mexico, Portugal and Spain



***Spain and Portugal's accession to EU ** NAFTA was announced**

Source: International Financial Statistics, various issues.

The FTA as a Policy Reform Anchor

In addition to providing market access and increasing FDI, a FTA with the United States may serve to support Egypt's reform efforts. Like Mexico, Egypt could use the FTA with the United States to further enhance the credibility of its reform effort, which has intensified in the 1990s. Without a similar agreement, large foreign investors, especially those interested in asset-specific sectors in utilities, will either refrain from investing heavily in these sectors or require a high-risk premium to do so. An agreement with the United States, which involves liberalization of services, can reduce this risk and attract capital at favorable terms to Egypt. Risk will be even further reduced if foreign investors believe that the United States will support the Egyptian economy in the event of a crisis, as it did in the Mexican case.[10]

There are several counter arguments to extensive commitments on the part of Egypt in the context of the FTA. First, Egyptian economic reforms have gained the confidence of foreign investors already, especially in the last couple of years. This is supported by the favorable rating Egypt recently received from Standard and Poor's and IBCA. Second, Egypt is about to sign an agreement with the European Union, which reduces the merits of using the FTA with the United States as a policy anchor.

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[10] See Francois (1997) for elaboration of the role of the US in the Mexican crisis and the favorable effect of NAFTA as a policy anchor for Mexico.

Finally, there is the loss of control over domestic policies that is associated with signing an external agreement.

These arguments are not, however, persuasive. The history of reform in Egypt is too recent. Notwithstanding the favorable institutional rating, there may be some investors who are hesitant to become involved in Egypt. Also, the agreement with the European Union is somewhat limited, involving no commitments with respect to the right of establishment or liberalization of services (Hoekman and Djankov 1997). As a result, foreign investors may not view it as a serious commitment mechanism as they did with NAFTA. The more difficult issue is the tension between national sovereignty and international commitments. This involves a trade-off, which cannot be dismissed lightly. But the most reasonable resolution of this tension, it seems, is not to forego the benefits of using the FTA as a binding mechanism. Rather, effort should focus on agreeing on reforms that are consistent with Egypt's reform strategy, and on including precise language in the agreement for dealing with exceptional circumstances.

٤. Potential Benefits to Egypt from a FTA with the United States: Responsiveness of the Egyptian Economy

Whether the potential benefits of a FTA with the United States are fully realized or not depends on the ability of the Egyptian economy to fully exploit the opportunities offered by the agreement. Less than prudent macroeconomic management, institutional rigidities, and excessive protection of domestic markets all effectively deter FDI, erode the ability of firms to export to a market as competitive as that of the United States and provide incentives to sell domestically rather than abroad. The question therefore is whether recent and on-going reforms in Egypt prepared the economy to take advantage of a FTA with the United States. This question is addressed in this section by evaluating reforms to date, identifying the remaining weaknesses and outlining the way the agreement could help further reform.

Reforms to Date

If someone asked whether the macroeconomic policy environment in Egypt was credible and conducive to attracting FDI and promoting exports in the 1980s, the answer would have been "no."[١١] Today, the answer to the same question would be an

[١١] On the importance of macroeconomic variables for FDI, see for example, UNCTAD (1992, 1993) Bajo-Rubio and Sosvilla-Riveroi (1994) and Haddad and Harrison (1993).

unqualified "yes." That is not to say that the macroeconomic environment is problem-free, or that further reforms are not needed. Rather, it says that things have improved significantly in the 1990s. Some may even argue that the Egyptian stabilization program is one of the most successful in the developing world (Subramanian, forthcoming). So how did this occur?

It occurred with the assistance of the IMF and World Bank. Egypt launched a major stabilization program in 1991 in the tradition of what is known as the Washington consensus. What distinguishes the Egyptian program, however, is how decisive the actions were -- especially on the fiscal front where the budget was reduced from above 15 percent of GDP to 1.3 percent in 1994/95. Otherwise, the program included exchange rate unification and devaluation, tight monetary policy and interest rate liberalization and price decontrol. This effort was aided by the forgiveness of 50 percent of Egypt's external debt following the Gulf War.

The program produced remarkable results. Inflation declined to 7.1 percent in 1995/96 -- down from 21 percent in 1990/91. External debt fell from 84 percent of GDP in 1992 to 46 percent in GDP in 1996, and the current account remained in surplus for most of the period. Increased confidence in the Egyptian economy was seen in rapid de-dollarization which went from about 50 percent in 1991/92 to about 24 percent in 1995/96. Moreover, the build-up of capital inflows increased reserves to $20 billion or about 9 years of current debt servicing requirements. Finally, while GDP growth slowed down considerably during the reform period, it has shown signs of recovery in recent years. Real GDP growth was 5.0 percent in 1996/97 and is expected to increase further in the next few years. By 1997, the cumulative effect of these reforms earned Egypt a rating of BBB-- from Standard and Poor's and IBCA.

But stabilization is only a precondition for economic agents to respond flexibly to market challenges and opportunities. Without structural reforms to reduce transaction costs, to enforce contracts efficiently and to restore flexibility in the labor and capital markets, the "right" prices may not be acted upon (Benham 1997). Here too, the government has made significant progress. A comprehensive account of what has been accomplished is difficult, but the highlights include opening up the economy, reducing the dominant role of the state and developing the financial sector. The reforms have been undertaken also with the support of the IMF and World Bank while others have been done unilaterally.

In terms of openness, Egypt's trade liberalization started in 1991 with the removal of import bans and export controls. Progress continued with regular reductions of maximum and average tariff rates. As a result, the average tariff rate is now only 16 percent with a maximum rate of 50 percent (excluding automobiles, cigarettes and alcohol). Because tariffs are also imposed on imported intermediate inputs, effective rates of protection (ERPs) of domestic producers are lower than nominal rates which declined from 13.1 percent in 1992 to 9.1 percent in 1996.[12] This more-open trade regime has had the effect of exposing firms to greater foreign competition, thereby enhancing their capacity to respond more favorably to improved market access abroad.

In an attempt to reduce the dominant role of the state, the government accelerated the privatization of state-owned enterprises (SOEs), especially in the last couple of years. In 1996/97 alone, privatization involved the sale of the majority of the shares of 40 companies, out of some 300 SOEs, and by 1998/99 the government intends to complete the sale of the remaining two-thirds of public sector companies. In light of the experience of other countries, privatization is expected to improve efficiency, increase investment and contribute to consumer welfare without hurting workers (Galal, et al.1994). Since 1991, the government has simultaneously introduced major pieces of legislation involving the reduction of taxation and the elimination of exchange and credit controls.[13] Other laws have been passed to ease entry into the banking sector, including the 1996 bill that allows 100 percent foreign ownership of banks. In 1997 a new investment law was passed by parliament, unifying and simplifying the procedures necessary to undertake new investment and giving the private sector incentives to invest.

In the financial sector, significant reforms have also begun. In banking, reforms started when government funds were injected to compensate banks for earlier structural weaknesses and for an overregulated financial sector. Since then, the government has introduced several policies to strengthen the banking sector and improve its ability to meet the needs and risks of a liberalized environment. Banks are allowed to set their interest rates and service charges and can operate freely in local or

[12] See Appendix for data sources and details of calculations.

[13] The marginal tax rate was reduced from 65 percent to 48 percent and the People's Assembly just passed a law reducing it even further (40 percent for the highest income bracket). The corporate rate was reduced to 42 percent and 34 percent for manufacturing.

foreign currencies. All but one of the joint-venture banks have been privatized and the banking sector's involvement in corporate and consumer credit is growing.[14]

Helped by the privatization program, efforts to strengthen the Egyptian stock exchange have paid off. Capitalization/GDP went up from 7 percent in 1991/92 to an estimated 24 percent in 1996/97. Yet some argue that the growing importance of the stock market came at the expense of the banking sector (Subramanian 1997). Further liberalization of trade and investment could bring this trend to a halt, hence the importance of a FTA agreement that liberalizes trade and investment between Egypt and the United States. As the domestic sector responds to new investment and trade possibilities, competition between various sources of finance can guarantee improved allocation of resources, even if the banking sector itself is excluded from service liberalization.

Reforms to date appear to have prepared the Egyptian economy to enter a FTA with the United States. Such a proposal in the 1980s would have fallen on deaf ears or met with skepticism.

Remaining Weakness of the Economy

Despite progress, some weaknesses remain. The current account is expected to show a deficit in the next few years, and as a result, further tariff reductions and the poor performance of non-oil exports. Over the past few years, non-oil exports hardly grew, and their share relative to GDP is a modest 3.5 percent. This ratio compares with 15 percent in Indonesia. An important reason for the poor performance of non-oil exports is an overvalued exchange rate, which was estimated at 30 percent between July 1991 and December 1996 (Subramanian, 1997).[15] While receipts from services have grown by 29 percent between 1991/92 and 1996/97, other service exports such as communications, media, shipping, engineering and Arabic software remain virtually unexploited.

Another area of weakness is the low level of savings and investments. The share of investment in GDP is approximately 17 percent of GDP, which is far below the same ratio in dynamic export-oriented countries such as Indonesia (37 percent in 1996).

[14] The health of the banking sector is evidenced by an improved profitability. The limited spread between borrowing and lending rates (3.8 percent in 1995/96) and the smaller exposure of banks to public companies debt (share of public sector credit is 57 percent in 1996. Down from 71 percent).

[15] Egypt uses the exchange rate as a nominal anchor.

One reason for low savings is the large public sector, with SOEs alone accounting for about 30 percent of GDP (Sachs 1996). Another reason is the pay-as-you-go pension fund system, which provides pensioners limited incentives to save. Third, the low investment ratio is in part related to the low level of FDI, which suggests that foreign investors consider Egypt less attractive than other emerging markets in East Asia and Latin America.

Finally, because savings, investment and exports have been low, the economy did not grow fast enough to create sufficient jobs to absorb the growing labor force. Admittedly, the policy of guaranteed employment in the public sector was successful for decades in maintaining near full employment, even if these jobs were not productive. But this policy proved unsustainable and left the economy with an unemployment challenge that is yet to be met. The unemployment rate is estimated at 10 to13 percent (Fergani 1994). Underemployment is much larger.

Accordingly, the reform agenda is hardly finished, if it ever will. Further structural reforms are awaiting action. Indeed, evidence shows that if Egypt were to improve its economic and institutional environment to meet the standards prevailing in East Asia, the Egyptian GDP per capita could increase by as much as 6.3 percent (Sachs 1996). Also, a survey of the private sector suggests that the costs of red tape and other institutional constraints still burden business by as much as 15 percent (IBCA 1997).[١٦]

Readiness of the Economy and the FTA

The favorable economic environment and the weaknesses of the economy make a FTA with the United States attractive for Egypt. This environment encourages investment and exports and enables firms to take advantage of the opportunities offered by the agreement. The weaknesses of the economy, on the other hand, attest to the need for a FTA to reduce the saving-investment gap, penetrate new markets, and build the credibility of reform. Because the reform agenda is not finished, the FTA may also be used to support further reform. At the level of specific industries, the FTA could also help. This is illustrated by a brief analysis of three export categories: textiles, agricultural products and non-traditionally comparative advantage sectors.[١٧]

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[١٦] See also, World Bank (1992, 1994).

[١٧] Under the non-traditionally comparative advantage sectors we group all manufacturing sectors except food processing, textiles, minerals and oil refining.

Consider textiles first. Judging by the Revealed Comparative Advantage (RCA) of Egyptian exports to the United States, Egypt enjoys a comparative advantage in 8 of 10 HS2-digit textile sectors (Table 4). Therefore, this sector shows a fair degree of competitiveness in that market, despite the presence of existing trade barriers in the United States.

Table 4. RCA* for Egyptian Textiles, 1994 (Percent)

	World	USA
Silk yarn and fabrics	-252	
Wool yarn and fabrics	-239	602
Cotton yarn and fabrics	373	619
Other natural fiber yarns and fabrics	119	
Manmade filament	-211	14
Manmade staple fibers	-252	-58
Wadding, felt and unwoven; yarn; twine;cordage	-19	
Carpets and other textile floor coverings	311	731
Special woven fabrics;tufted textile fabrics; lace; tapestries	37	61
Impregnated, coated, laminated textile fabrics	-178	-137
Knitted or crocheted fabrics	4	
Apparel and clothing accessories, knitted or crocheted	371	774
Apparel and clothing accessories, not knitted or crocheted	464	762
Other made-up textile articles; worn clothing	379	777

*$RCA(\%) = \ln((X_i/X)/(M_i/M)) * 100$
where X_i and M_i are sector i's exports and imports, respectively,
While X and M are Egypt's total exports and imports.

RCA>0 indicates the presence of comparative advantage. The higher the index the more successful the trade performance of the sector in question.

Source: Calculated from CAPMAS trade data.

This conclusion holds although ERP was 31.5 percent in 1996 for spinning and weaving and 40.7 percent for ready-made garments in the same year (Table 5).[١٨] Accordingly, an Egypt-US FTA that ensures duty-free access of Egyptian textiles to the United States could be instrumental in promoting this sector.

As for agricultural products, negative ERPs have been rising in absolute terms during the period 1992-1996 (Table 5). Accordingly, greater access to markets abroad is likely to lead to a greater supply of these products. The problem is that agricultural

[١٨] ERF calculations do not take into account the effect of the ban on imports of ready-made garments. Therefore the ready-made garment industry is necessarily more protected than the ERP figures suggest.

products are usually subject to extensive quality and specification controls. Harmonizing these procedures in the framework of a FTA with the United States can interact with negative protection to assure the ability of this sector to penetrate the US market.

In non-traditional, non-oil industries, the expected downward trend in ERP measures after the full implementation of the FTA with the European Union indicates a similar potential for many products. According to Galal and Hoekman (1997), only 4 of 13 industries will remain positively protected by year 2010. This means that these are sectors that will be able to compete effectively in a more open trade environment.

Table 5. Protection in Egypt, 1992 and 1996*

	1992		1996	
	Nominal Tariff	ERP	Nominal Tariff	ERP
Agricultural food products	6.0	0.1	3.3	-4.4
Agricultural non-food products	4.5	-2.2	4.2	-2.3
Livestock	9.1	3.9	7.9	4.4
Oil and Gas Extracts	5.0	-9.9	5.0	-12.2
Other Extracts	8.3	-6.6	8.0	-7.4
Food Processing	7.5	2.4	7.2	3.1
Cotton Ginning	7.5	2.5	7.5	2.8
Spinning and Weaving	44.6	47.9	31.1	31.5
Ready-made Garments	99.3	82.6	54.4	40.7
Leather Products (less footwear)	22.5	32.0	21.6	31.0
Footwear	83.0	73.2	53.6	42.2
Wood Products (Less Furniture)	9.1	-15.0	8.8	-11.2
Furniture	87.8	105.9	48.2	53.8
Paper & Printing	16.0	12.6	17.8	15.3
Chemical Products (less oil refining)	12.7	6.6	11.4	5.7
Oil Refining Products	9.4	6.0	9.4	6.0
Rubber & Plastic Products	17.0	6.6	14.7	5.3
Porcelain Products	29.3	20.6	26.3	17.4
Glass Products	40.5	32.0	32.0	23.8
Non-metallic Products	40.5	39.9	17.7	12.8
Metals and Iron Products	13.6	18.5	13.0	17.9
Machinery & Equipment	25.0	14.5	19.8	9.4
Transportation Means	40.2	36.1	56.9	58.8
Other manufacturing industries	25.6	18.3	10.9	2.5
Weighted average	20.9	13.1	16.8	9.1

*Beverages and tobacco are excluded because of their high nominal tariffs

Source: Calculated

These are also the sectors that can benefit significantly from simplified and harmonized import and export procedures, which now represent trade barriers, especially for small exporters.

5. Concluding Remarks

The economic relationship between Egypt and the United States is relatively important for Egypt, but remains aid-dependent and undiversified, with a growing trade deficit in favor of the United States. The debate over aid to Egypt, despite the importance of this relationship to both parties, suggests that a FTA between the two countries may be the logical next step. Aside from the immediate benefits of net trade creation and increased investment, a strong relationship between the two countries will help foster peace in the region.

Not all FTAs are equally beneficial, however. This paper argues that an eclectic FTA, covering trade liberalization and the harmonization of *some* domestic policies and regulations, is the best option for Egypt. A “deeper” FTA, such as NAFTA, may infringe on national sovereignty and impose inappropriate policies and institutions on Egypt. In contrast, a “shallow” FTA, such as that between the United States and Israel, may do very little to promote investment, liberalize services and provide an anchor for policy reform.

The time to negotiate an agreement with the United States is now. Because Egypt is about to conclude an agreement with the European Union and has signed a FTA with the Arab countries, an agreement with the United States will reduce trade diversion. At the same time, the Egyptian economy is essentially ready to take advantage of an agreement with the United States, given the significant reforms undertaken in the 1990s. Whatever weakness remains in the economy, the FTA with the United States can indeed be a helpful force.

Appendix

Effective Rate of Protection (ERP)

The Effective Rate of Protection (ERP) measures the extent to which nominal tariffs protect domestic Value Added (VA). A positive ERP indicates that domestic VA is protected, while a negative ERP indicates that domestic VA is taxed. The ERP for sector I was calculated as [١٩]

$$ERP_i = \frac{Tariff_i - \sum_{j \neq i} Tariff_j * a_j}{1 - a_i} * 100$$

where a_j is the input share of sector j in the production of sector i calculated from the 1991/92 input-output (IO) table for Egypt; and $tariff_i$ is the imports weighted nominal tariff of sector i of the IO table.

Data on merchandise imports were obtained from CAPMAS at the 2-digit level of the HS classification. Tariffs applied in 1992 and 1996 were obtained from the Presidential Decrees 351 (1986) and 38 (1994) and their amendments. As the data on tariffs were more detailed than the data available on imports, the 8-digit 1994 imports were used to derive weighted tariffs for the 2-digit imports. The trade and tariff data were then regrouped to correspond to the sectors of the IO table.

Because there are no tariffs on services, and inefficient services impose a tax on manufacturing and agriculture, “tariff equivalents” were assumed for the different service categories of the IO table based on comparative efficiency indicators. 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. The same rate was also applied to the insurance sector. A 50 percent tariff equivalent was assumed for the communication sector based on a comparison of the number of employees per line in Egypt with the world average. Based on comparative information on the cost of shipping and loading, 30 percent was assumed for shipping and warehousing. No tariff equivalents were assumed for the other service sectors.

[١٩] For the derivation of ERP see Hoekman and Djankov (1997).

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