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Overview

The Middle East's political importance to the United States is evident in the political capital US administrations have invested to resolve the conflict between Palestine and Israel, the amount of aid extended to Egypt and Israel, and the willingness of the United States to wage a war in Iraq. It is thus not surprising that political more than economic considerations have driven US free trade agreements (FTAs) in the region, both the FTAs that the United States has already concluded (with Israel, Jordan, Morocco, and Bahrain) and those that it is contemplating with other countries in the region and with the region as a whole. It can be argued that FTAs between the United States and Middle Eastern countries are fundamentally about potentially large political (and consequently economic) gains for the United States, while the potential gains to the countries themselves are mostly economic in nature (and consequently political).[1]

Nonetheless, it is risky to focus on politics alone. The history of the Middle East is replete with failed regional economic initiatives that were motivated purely by politics and not supported by the necessary economic measures. In the long run, not only did these initiatives fail to produce economic benefits but also their failures ultimately led to disillusion, disappointment, and a loss of credibility which inflicted political damage as well. Exacerbating this problem is the tendency, over time, for people to take political gains for granted, which requires increasing economic benefits to offset the perceived losses.[2]

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1. See Gresser (2003) for the case that freer trade supports the war against terror.

2. It could be argued that the European Union, which was motivated politically to begin with, can attribute its successful creation and evolution to its members' recognition of the economic benefits.

Thus, even if signatories to a bilateral FTA are interested mostly in its political benefits, they must appraise its economic soundness and recognize that it is not assured. The key costs of trade diversion need to be weighed against the benefits of trade creation and the dynamic benefits from stimulating productivity growth and investment enhancing policy credibility, and reinforcing domestic economic reforms and institutional development. The answers to these questions, to be discussed in this study, depend heavily on the form the agreement takes and the other policies that accompany it: in particular, (1) whether the agreement focuses simply on border barriers (shallow integration) or includes investment services and other rules and institutions (deeper integration) and (2) whether the agreement is seen as sufficient in itself or is used to leverage domestic economic reforms. Even if the net benefits are positive, it is crucial to understand whether the agreement detracts from or complements multilateral liberalization, which could be even more beneficial.

The idea of a US-Egypt FTA is not new: Egyptian President Hosni Mubarak and US Vice President Albert Gore agreed to explore the possibility in April 1997. When we last studied the question seven years ago, we pointed to the considerations leading each side to take an interest in such an agreement (Galal and Lawrence 1998). For Egypt, we noted that an agreement could spur measures to further liberalize the domestic economy and integrate into the world economy. For the United States, whose relationship with Egypt had been based primarily on strategic and political considerations, an FTA would indicate a willingness to promote the economic dimension and facilitate development. It would also further broaden the web of preferential arrangements between the United States and its trading partners.

In that study we concluded that an agreement with appropriate terms could benefit both parties. For Egypt, an agreement with the United States offered the potential both for offsetting some of the trade diversion effects of its other regional agreements, particularly with the European Union and its Arab neighbors, and for moving more ambitiously in its liberalization efforts by including services, investment, and agriculture. For the United States, though the economic benefits of an agreement would be small, there could be significant political benefits from shifting the US-Egypt relationship toward more trade and investment and less aid and from adding an economic dimension to the peace process that at the time was making progress.

However, each side was somewhat reluctant to move forward. Egypt not only faced challenges in adjusting to competition with the United States but also had concerns about what the United States might demand in an agreement, such as labor and environmental standards that would be difficult for Egypt to meet and thus used to deny Egypt the full benefits from an FTA. The United States was concerned that congressional approval of an agreement might be difficult to obtain since the US president did not yet have so-called fast-track negotiating authority. Worries also existed about the pace of Egyptian economic reforms and the possible problems for US firms and exporters in dealing with Egyptian government rules and bureaucracy. While free trade might be declared on paper, would it be delivered in reality?

It is fair to say that these concerns stalled the process, and our book *Building Bridges: An Egypt-US FTA* was received with polite interest rather than overwhelming enthusiasm on both sides. In 1999, the United States and Egypt signed a trade and investment framework agreement (TIFA), which established a TIFA Council designed to facilitate the discussion of bilateral trade and investment issues. The council met in October 2002 and established working groups to review technical issues relating to agricultural trade, customs administration, and government procurement. The two countries appeared to be close to launching FTA negotiations in June 2003, only to have a falling out when Egypt withdrew its support for a World Trade Organization (WTO) case launched by the United States against the European Union over genetically modified organisms (GMOs).

Despite this, developments in US trade policy, global politics, the US-Egypt relationship, and Egyptian domestic policies since 1998 all enhance the desirability of an agreement. The US trade policy environment has become more favorable in important respects. In June 2002, the US president was granted trade promotion authority (TPA), making trade agreements subject only to a single yes-or-no vote by Congress and thus allowing the US administration to assure its negotiating partners that they would obtain precisely the deals they struck. In addition, the United States has adopted a strategy of "competitive liberalization" based in part on concluding bilateral and multilateral FTAs with a large number of partners.[3] As we will elaborate below, Egypt certainly merits strong consideration for inclusion in this strategy.

Third, the terrorist attacks on September 11, 2001, have dramatically raised US interest in fostering economic development in the Middle East. President George W. Bush indicated a commitment to support integration of the region into global markets in a commencement address at the University of South Carolina on May 9, 2003, when he proposed "the establishment of a US–Middle East free trade area within a decade."[4] US Trade Representative Robert Zoellick remarked before the World Economic Forum in Jordan on June 23, 2003, that a regional FTA with the United

3. FTA negotiations under this strategy have already been concluded with Jordan, Chile, Singapore, Australia, Morocco, and Bahrain. Negotiations with Central American nations have been completed. Negotiations for further agreements have been announced and launched with Panama, Colombia, Ecuador, Peru, Thailand, the five nations of the Southern African Customs Union (SACU), Oman, and the United Arab Emirates. For an assessment of these FTAs, see Schott (2004).

4. President Bush's speech is available at www.state.gov/p/nea/rls/rm/20497.htm.

States is the ultimate goal, achieved by a series of cumulative measures that include actively supporting WTO membership for "peaceful countries that seek it;" increased use of the Generalized System of Preferences (GSP); negotiation of TIFAs, which often precede FTAs; bilateral investment treaties (BITs); bilateral FTAs such as those that have been negotiated with Morocco and Bahrain; and, the extension of these agreements to include neighboring countries and, in time, the whole region.[5] A US-Egypt agreement would certainly have to be part of any comprehensive FTA with the Middle East.

There is also more evidence that such agreements can work. The trade agreement between the United States and Jordan has been astoundingly effective in stimulating trade. In 1999, US imports from Jordan amounted to a paltry $31 million dollars, US apparel imports from Jordan were negligible ($2.2 million), and the United States had a trade surplus of $239 million. In 2004, US imports were almost $1.1 billion, of which $956 million was apparel. US exports to Jordan also increased significantly, from $270 million in 1999 to $531.4 million in 2004. Jordan's bilateral merchandise trade balance with the United States shifted from a deficit of $239 million to a surplus of $562 million. The remarkable increase in Jordanian exports, which come mainly from a set of qualifying industrial zones (QIZs), demonstrates how rapidly a country can take advantage of trade preferences, particularly in apparel.[6] Jordan has become a regional textiles hub. The contrast between Egypt and Jordan over this period is especially striking. In 1999, Egyptian exports of textiles and apparel to the United States were $332 million, about 167 times larger than those of Jordan.[7] In 2003, Jordan's exports of apparel were 43 percent larger than those of Egypt.[8]

The US-Egypt relationship has continued to evolve. Although Egypt was given special assistance to deal with the aftermath of September 11,

5. Zoellick's remarks are available at www.ustr.gov/Document_Library/USTR_Zoellick_Speeches/2003/Global_Trade_the_Middle_East.html.

6. The record of Jordanian QIZ exports is particularly remarkable because QIZ products are required to contain at least 8 percent Israeli content.

7. According to Merzaban (2004), some Egyptian textile producers have lobbied the government to seek similar QIZs for Egypt.

8. The US-Jordan Free Trade Agreement entered into force on December 17, 2001. It eliminated duties and commercial barriers to bilateral trade in goods and services originating in the United States and Jordan. It also included, for the first time in the text of a trade agreement, provisions addressing trade and environment, trade and labor, and electronic commerce. Other provisions addressed intellectual property rights protection, balance of payments, rules of origin, safeguards, and procedural matters such as consultations and dispute settlement. Because the United States already has a bilateral investment treaty with Jordan, the FTA did not include an investment chapter; see text of agreement at www.ustr.gov/Trade_Agreements/Bilateral/Jordan/Section_Index.html?ht=fta%20jordan%20 (accessed March 25).

the United States plans to reduce economic assistance, partly because of budgetary pressures and partly under the assumption that increased trade will replace it. The signing of an agreement for QIZs in December 2004 was an important step in this direction. It allowed duty-free access to the United States for textiles and apparel that are produced in particular zones in Egypt and meet specific rules of origin.[9] However, a QIZ is not a substitute for a full-fledged FTA. Aside from its restrictive rules of origin, the basic weakness of the QIZ is that it operates in isolation from the rest of the economy, making it far less likely to trigger complementary reform policies that would have widespread effects.

Two reasons are generally given for the procrastination in launching FTA negotiations; in our view, they actually made the need for an FTA more urgent, but in any case, both have become less compelling as time has passed. The first reason was the pace of Egypt's economic reform process. From 1991 to 1998, Egypt successfully implemented a comprehensive stabilization program and initiated significant structural reforms, including traditional reforms, such as multilateral trade liberalization, privatization of banks, and deregulation of utilities, as well as institutional reforms to reduce transaction costs, such as customs administration, tax administration, and conflict resolution mechanisms.[9] After 1998, the reform process slowed. For some, the slowdown confirmed doubts about Egypt's suitability as a trading partner. In our view, it actually increased the importance of an FTA with Egypt, because a US-Egypt FTA conditioned on domestic reform measures would strengthen the reform movement.

More recently, these concerns should have been allayed because the reform process gained momentum in Egypt following the appointment in July 2004 of a new cabinet filled with what the Economist Intelligence Unit termed "well-regarded economic liberals" (EIU 2005). New reforms included significant trade liberalization that reduced the weighted average tariff rate from 14 to 9 percent and the number of tariff bands from 27 to 6. The government has also initiated deliberations for a new income tax law, which will reduce the maximum rate to 20 percent, down from 42 percent for services and 34 percent for industrial activities. Other reforms are under way, including privatization, financial-sector reform, and political reforms.

9. Products must be made in three QIZs: Alexandria, Cairo, and Port Said. They are given duty-free access to the United States if they have a minimum of 35 percent local content, one-third of which (11.7 percent) must be produced in Israel, one-third in the United States, and one-third in Egypt.

10. According to the USTR report on foreign trade barriers (2003), "Most recently, over the last two years, progress on trade reform has been uneven. Although the government recognizes the need to eliminate nontariff barriers to trade, cumbersome bureaucracy and rigorous enforcement on Egyptian standards remain significant problems and add to the cost of doing business."

The second reason for delay was the loss of trust between Egypt and the United States after the fallout over the WTO case brought by the United States against the European Union regarding GMOs in May 2003. Initially, Egypt agreed to side with the United States as a co-complainant. However, within a week it reversed its position as the implications for its relationship with the European Union became clearer. In the United States, this shift raised questions about Egypt's reliability. While there remained considerable support within the US administration for an agreement, the enthusiasm of the United States trade representative (USTR) waned dramatically. In Egypt, the reaction of the United States raised concerns that it might use the FTA to pressure Egypt on other political issues. Critics argued that if just the launching of negotiations for an FTA could be used in this way, the implementation of strong economic links through an FTA could render Egypt even more vulnerable.

As the Egyptian response indicates, using FTA negotiations to exert political pressure is counterproductive. If negotiations are exploited to achieve short-run political gains, the long-term political payoffs from creating a more secure economic relationship will surely be undermined. But instead of trying to limit its economic engagement with the United States to reduce such pressures, Egypt would be better served by strengthening the relationship, establishing a legally binding set of rules in an FTA that provides a framework invulnerable to the vicissitudes of political events. A formal and binding FTA places much of the economic interaction between the countries on a separate track.

Other developments also make the case for an agreement more compelling for both countries. Egypt has already signed an FTA with Arab countries—the Greater Arab Free Trade Area (GAFTA)—and has now concluded its association agreement with the European Union. As these agreements are implemented and their competitors begin to enjoy duty-free access to Egypt, US exporters will be increasingly disadvantaged in the Egyptian market. It will become harder to square extensive financial assistance to Egypt with discriminatory treatment of US exporters.

Similarly, Egyptian producers are keen on securing access to US markets in a way that matches the duty-free access accorded to Israel (because of the US-Israel FTA), Canada and Mexico (through NAFTA), and other FTA partners. This access is particularly important for Egypt, given that the United States is its second most important trading partner after the European Union. It has become particularly important for Egypt with the expiration of the Multi-Fiber Arrangement (MFA), which has eliminated quotas on Egyptian competitors.[11] Absent an FTA with the United

11. The MFA implemented under GATT in 1974 allowed developed countries to protect their markets for textiles and clothing with a system of quotas imposed on developing-country exports. The agreement expired in January 2005.

States, there would be significant trade diversion and loss of welfare for Egyptians.

To be sure, skepticism still exists about both the desirability and feasibility of an FTA between Egypt and the United States. Critics in both countries oppose trade liberalization and view globalization as a trend to be resisted rather than promoted. Others support free trade in principle, but only if it is achieved through multilateral rather than preferential trade agreements (e.g., Bhagwati 1993). Surely trade liberalization is not a panacea, and there are questions to be asked about the optimal pace of liberalization because of the adjustment costs. In addition, the fruits of trade liberalization can only be realized if accompanied by complementary institutional changes. However, there is overwhelming evidence that economic growth and trade are positively associated (e.g., Sachs and Warner 1995). As for achieving free trade through multilateral agreements, the train has already left the station. Egypt has embarked on the course of concluding bilateral and multilateral agreements with Europe and other regional partners. So has the United States. Thus, the relevant question is whether a US-Egypt FTA would be a useful complement to these sets of agreements.

The remainder of this volume is organized as follows. Chapter 2 considers the current political and economic context and argues that an FTA that supports reform efforts could not only enhance Egypt's economic development but also have a positive demonstration effect throughout the Middle East. At the same time, however, the chapter highlights some of the challenges facing the Egyptian economy, the progress to date in dealing with them, and the tasks that still need to be done. Finally, it argues that the current pattern of the economic relationship based heavily on US aid will not be sustained when the scheduled reductions in assistance come into effect.

Chapter 3 discusses in broad terms what a US-Egypt FTA might look like. It argues that from both an Egyptian and US standpoint, an agreement that is relatively comprehensive (i.e., covering goods, services, and investment) and deep (dealing with both border barriers and domestic regulatory policies) is desirable. For Egypt, with appropriate provisions, such an agreement is most likely to yield the largest benefits in stimulating additional reforms and improving the environment for domestic and foreign investment. For the United States, such an agreement offers the greatest benefits in dealing with the problems faced by US exporters and investors in Egypt and in promoting broader US trade policy goals in the region and the world at large. Chapter 4 reports the results of model simulations of a possible FTA, suggesting that there could be significant benefits for Egypt provided that the agreement is comprehensive and includes investment and services as well as nontariff barriers. The simulations demonstrate that a US-Egypt FTA would mitigate the trade diversion caused by other Egyptian preferential arrangements. It would produce static benefits of 1.6 percent of GDP, with gains for both Egyptian labor and capital. The direct economic impact on the United States would be small but positive.

Chapter 5 considers complementary policies that could make the agreement even more effective, emphasizing the contributions that a far-sighted view by negotiators can make in crafting an agreement that contributes to reforms. It is important for both sides to view the FTA as an opportunity to enhance Egyptian development rather than as a zero-sum negotiation. Also, for each side, the agreement's success depends crucially on the adoption of complementary measures. For Egypt, this requires additional policies to enhance Egyptian competitiveness and facilitate domestic adjustment. For the United States, it requires policies to promote peace in the region. Finally, the chapter points to the role of safeguards and adjustment assistance in helping those who may experience difficulties when the agreement is implemented. With a thorough negotiation process that focuses on long-term gains, both parties can realize the economic and political potential that an FTA between Egypt and the United States has to offer.