2

The Political and Economic Context

The terrorist attacks on September 11 marked a turning point in US–Middle Eastern relations, evidenced by the war in Iraq and the launching of several initiatives in support of reform in the region. One of these initiatives is President Bush's commitment to "the establishment of a US–Middle East free trade area within a decade," which he announced in his commencement address at the University of South Carolina on May 9, 2003.[1] More recently, the US government announced the Greater Middle East Initiative, submitted to the G8 in 2004.[2] This initiative draws on the Arab Human Development Report (UNDP 2002), which pointed out that the region suffers from deficits in three areas: democracy, knowledge, and gender equality.

Presumably, the US initiative stems from the belief that a prosperous and peaceful Middle East is good for the region and the United States. But not everyone in the region assumes this. On one hand, there are those who focus on the substance of recommended reforms and believe such reforms, with adjustments, are the kind of reforms the region needs. They see the initiative as a potentially useful mechanism for lending support to the reform process and enabling the region to catch up with emerging markets. They further believe that effective measures by the United States toward resolving regional conflicts would turn the attention of regional politicians toward domestic reforms. On the other hand, there are others

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

2. See the Middle East Intelligence Bulletin, www.meib.org/documentfile/040213.htm.

who are more skeptical about US intentions. To them, renewed interest by the United States in the region is motivated only by the desire to maintain a stable supply of oil and ensure the security of the state of Israel. They contrast the prompt action of the United States in Iraq with their slowness in dealing with the Palestine-Israel problem. They also point out that the United States has routinely supported nondemocratic regimes in the region in pursuit of narrow economic objectives.

The divergence of views regarding US intentions in the region suggests that all is not well, and a better relationship between the United States and the Middle East in the future depends on a number of confidence-building measures now. Well-designed free trade agreements (FTAs) between the United States and interested countries in the Middle East could be one of these measures. An FTA with Egypt, specifically, could have four concrete advantageous effects. The first is a demonstration effect, given Egypt's role as a regional leader and the tendency of its neighbors to emulate it. The second is a reform-boosting effect, given that the reform process in Egypt remains incomplete. The third is a diversion avoidance effect, because Egypt has entered into a number of FTAs with the European Union and other parties. The fourth is the sustainability of bilateral economic relations between the two countries, which currently draw heavily on aid to Egypt.

Demonstration Effect

By virtue of Egypt's size, location, and cultural and political leadership in the region, successful reform there could have a positive demonstration effect throughout the Middle East. Success in other countries could of course be contagious as well but probably not as much as in Egypt. Here is why.

Egypt is the largest Arab country, with 69 million inhabitants or about one quarter of the region's population. It is located at the heart of the Middle East. It produces most of the movies, TV programs, books, and music in Arabic. More than 2 million Egyptians are working in neighboring countries, as teachers, engineers, accountants, doctors, and in other occupations. Meanwhile, Egypt receives students in all fields of knowledge from neighboring countries. It is a travel destination for Arab tourists, and a crossroad for the transport of goods through the Suez Canal. Not surprisingly, Egypt's writers, culture, way of life, and colloquial Arabic are all well known and often emulated throughout the region.

Political leadership is no less important. Egypt earned its position as a regional leader through concrete actions. It has hosted the Arab League since its inception in 1945. It supported countries like Algeria in their struggle for independence. It has led both military and diplomatic efforts to resolve the Palestine-Israel conflict and was also the first country to make peace and continue to support the right of Palestinians to a homeland. These examples suggest that Egypt has the credibility to lead a reform movement in the region, perhaps more than any other country.

A similar story can be told about the evolving model of development adopted by Egypt over the past half century. After its revolution of 1952, Egypt followed a version of socialism that was subscribed to by others. The experiment lasted, with some success, until the mid-1970s. Since then, Egypt has shifted to a model of development that aims to restore a healthier balance between the state and markets (elaborated below). In parallel, it adopted a strategy of gradual political opening. The process involved the adoption of a multiparty system, granting the press greater freedom, and strengthening the role of civil society. While its economic and political transitions remain incomplete, the example provided by Egypt, together with the dramatic changes in Eastern Europe and elsewhere, is being emulated by other countries in the region.

Collectively, these attributes make Egypt a center of gravity in the Arab world. While individual countries in the region may be ahead of Egypt in certain reform areas, only progress in Egypt seems to extend significantly beyond its borders. If an FTA between the United States and Egypt supported the reform effort in Egypt, it could have positive spillover effects throughout the region, boosting reforms across the Middle East.

Reform-Boosting Effect

The reform process in Egypt has been steady but incremental. Political feasibility and social concerns have been important considerations throughout the process. When reforms picked up speed, as they did in the early 1990s, they were anchored by commitments Egypt had made to the International Monetary Fund (IMF) and the World Bank. This suggests that external agreements, such as US-Egypt FTA, may hasten the reform process.

Very briefly, up until the mid-1970s, Egypt's development strategy was essentially inward-looking and state-led. Outside of the agricultural sector, the state owned most of the productive assets, controlled prices, and managed the economy through central planning. In the following decade and a half, there was a partial departure from that strategy, with a focus on attracting foreign direct unvestment (FDI) and developing physical infrastructure through external borrowing. While this strategy paid off in higher economic growth and greater inflows of FDI, it eventually ceased to be useful. By the end of the 1980s, economic growth was sluggish, internal and external imbalances were unsustainable, and inflation, at about 27 percent, was too high for a country like Egypt. Lack of significant policy and institutional reforms proved that resources alone cannot generate sustainable growth and prosperity.

Reforms of the Washington Consensus variety gained momentum from 1991 to 1997, with the support of the IMF and the World Bank. The stabilization program brought the fiscal deficit down to 0.9 percent by 1997, mostly by reducing public investment. It also included tight monetary policy and capital-account and financial-sector liberalization. Finally, the exchange rate was unified, devalued, and used as a nominal anchor for the conduct of monetary policy. When these reforms are combined in one index and compared with the pace and intensity of reform in other developing countries during the same period, Egypt fares well (see figure 2.1).[3] Despite some shortcomings in the design of the program—for example, premature capital account liberalization—the reforms produced positive results.[4] Inflation dropped to 6.2 percent, the level of dollarization subsided, and the current account balance was in surplus. The black market for foreign exchange all but vanished.

The same period witnessed significant structural reforms. The most important of these liberalized trade, both removing almost all quantitative restrictions on imports and reducing tariff rates and their dispersion. As a result, average nominal and effective rates of protection came down (see table 2.1). Egypt also began privatizing state-owned enterprises. In 1997, it sold 83 firms for $2.4 billion, or 2.5 percent of GDP. Reforms of taxation left income tax unchanged (until recently) but included sales tax to boost government revenues. The combined index of these structural reforms, plus exchange rate deviation from purchasing power parity (PPP), indicates that Egypt was able at least to catch up with other reformers in the region (figure 2.2).[5]

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3. The index is a composite of current account balance, fiscal balance, inflation rate, and exchange rate premium. The four elements are given equal weights. All data are normalized using the formula:

$$X_{jt} = \frac{(W - V_{jt})}{(W - B)}$$

where X_{jt} is the normalization value j for year t,

V_{jt} the value of variable for country j in year t,

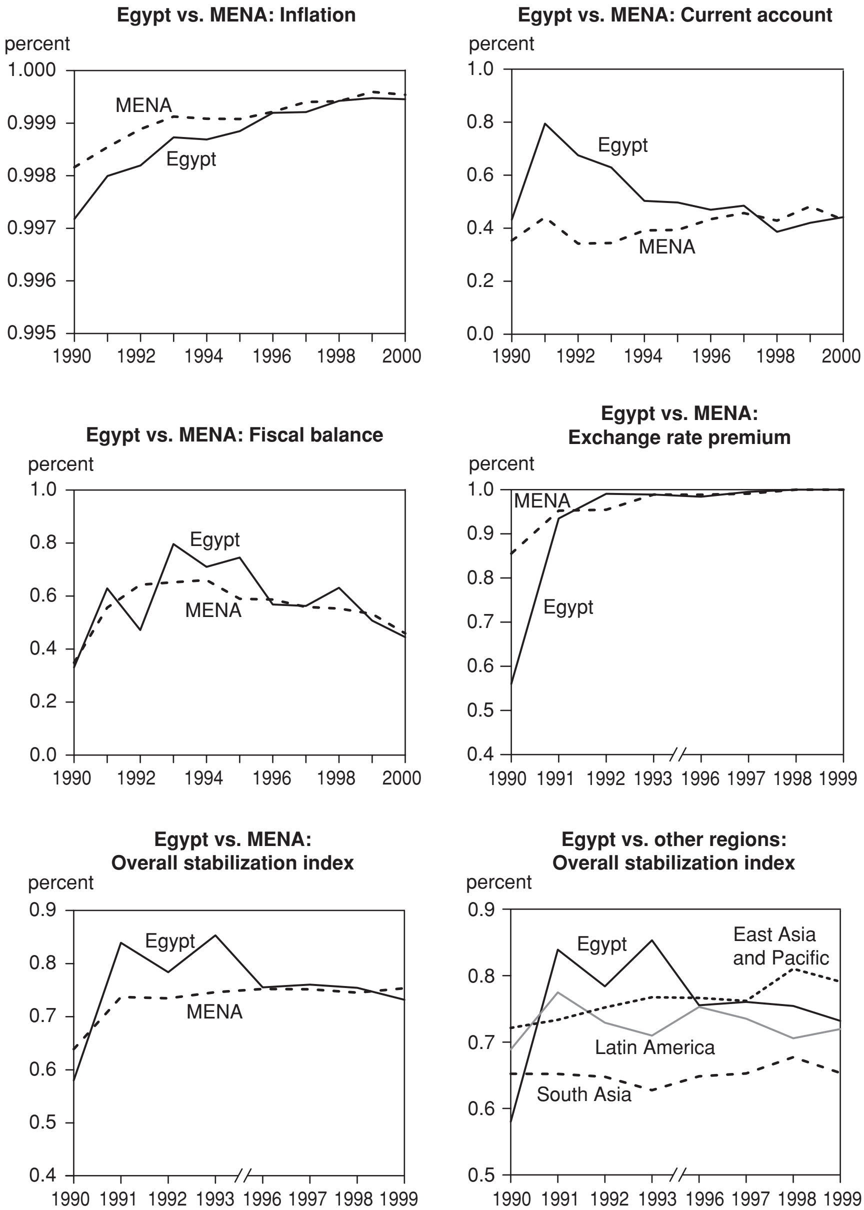
B best value for all countries and all years, and

W worst value of all countries and years.

4. For a positive review, see Subramanian (1997). For a critical review, see Abdel Khalek (2001).

5. This index is a composite of trade policy (measured by unweighted average tariffs), tax policy (measured by highest marginal corporate and individual tax rates), exchange rate overvaluation (measured by deviation from PPP), and privatization (measured by cumulative privatization proceeds as a share of GDP). The four elements are given equal weights, with the weight for tax policy equally divided between individual and corporate tax rates. All data are normalized using the formula in footnote 3.

Figure 2.1 Economic stabilization in Egypt versus MENA and other regions



Note: The index for Middle East and North Africa (MENA) covers Egypt, Jordan, Morocco, and Tunisia. Latin America covers Argentina, Bolivia, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. South Asia covers India and Pakistan. East Asia and Pacific covers China, Indonesia, Korea, Malaysia, Philippines, and Thailand.

Table 2.1 Rates of protection in the Egyptian economy, 1994, 1997, and 2004 (percent)

	Nominal protection level			Effective protection level		
Category of protection	**1994**	**1997**	**2004**	**1994**	**1997**	**2004**
Economywide protection						
Average protection (simple average)	27.9	22.2	13.6	36.7	28.5	17.5
Dispersion	23.9	16.7	14.0	30.8	21.6	15.0
Protection by sector						
Agriculture	8.3	7.9	6.5	7.3	7.0	6.0
Crude petroleum and natural gas	14.3	14.3	4.9	18.6	18.7	6.4
Other extractive industries	9.4	7.6	2.4	9.7	7.8	2.2
Manufacturing						
Food processing	8.7	8.0	5.7	8.1	7.5	5.3
Cotton spinning and weaving	34.5	28.2	12.9	52.0	42.4	18.9
Clothing	67.9	48.7	36.9	81.7	57.5	46.2
Leather products, excluding shoes	44.4	32.5	28.2	61.0	43.6	39.6
Shoes	70.0	50.0	32.0	94.5	66.2	40.0
Wood, wood products, excluding furniture	10.6	9.1	6.2	6.3	5.7	4.6
Furniture	69.7	49.9	30.3	99.0	70	42.4
Paper and printing	16.7	16.0	10.2	17.2	16.5	10.7
Chemicals and products, excluding petroleum	11.2	10.4	4.9	9.4	9.2	3.7
Rubber, plastic, and products	35.6	29.4	13.3	49.5	40.3	17.9
Porcelain, china, and pottery	47.6	36.2	26.6	62.0	46.7	35.6
Glass and products	34.7	28.0	15.6	40.2	32.2	18.1
Mineral products, nei	17.8	15.4	6.1	20.5	17.8	7.0
Iron, steel, and other base metals	20.0	16.1	6.9	22.2	17.8	7.4
Machinery and appliances	18.1	14.3	8.0	16.3	12.5	7.8
Transportation equipment	46.7	40.1	21.0	55.2	47.8	24.9

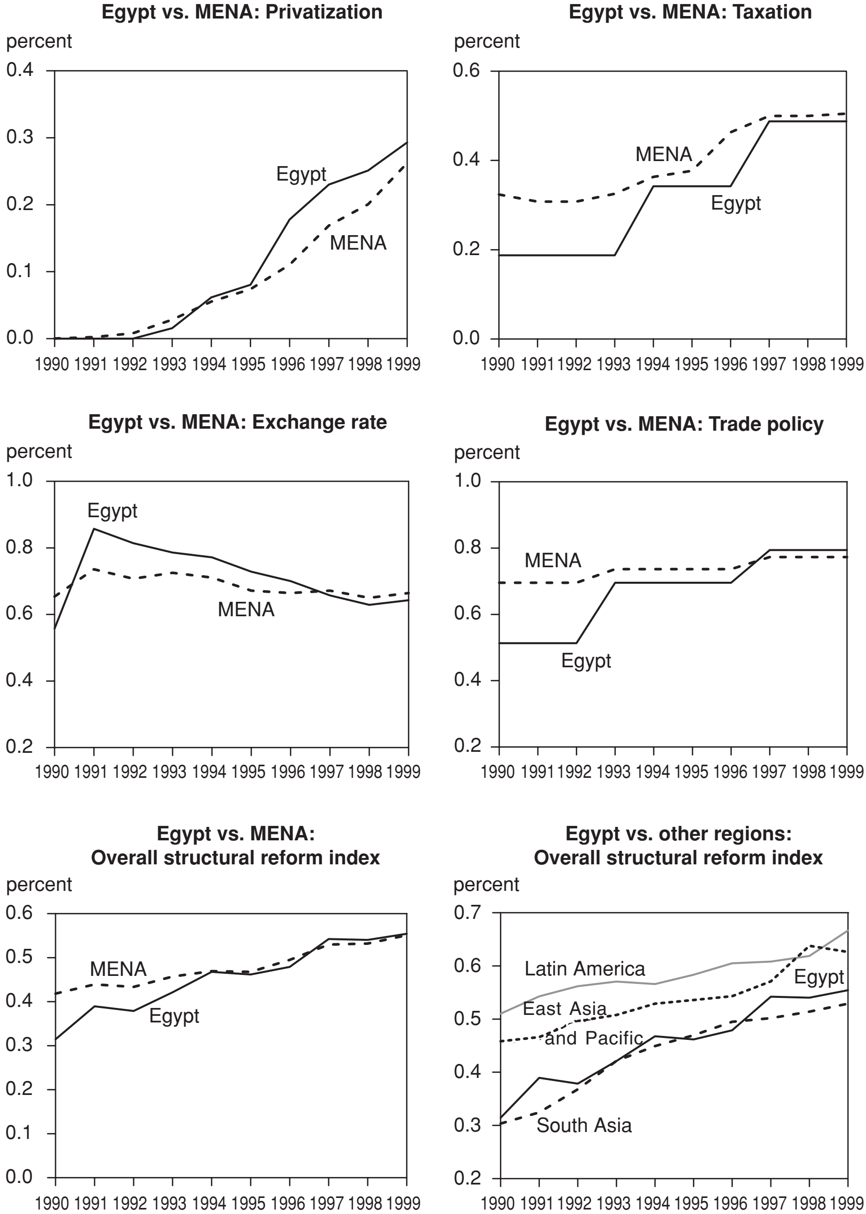
nei = not elsewhere included

Note: Economywide protection excludes beverages and tobacco.

Source: Authors' calculations.

Between 1998 and 2004, the reform process slowed down but did not stop. During this period, Egypt finally concluded an association agreement with the European Union, replaced the ban on imports of ready-made garments with specific tariffs (2002), and joined the World Trade Organization (WTO) Agreement on Customs Valuation (2001). It also gave up its peg to the dollar for an intermediate regime in January 2001 and abandoned that in January 2003 in favor of a floating regime. Measures to improve the business environment included a new labor law, a stronger intellectual property rights law, and a money-laundering law. In infrastructure and banking, the government awarded two cellular telephone

Figure 2.2 Structural reform in Egypt versus MENA and other regions



Note: The index for Middle East and North Africa (MENA) covers Egypt, Jordan, Morocco, and Tunisia. Latin America covers Argentina, Bolivia, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. South Asia covers India and Pakistan. East Asia and Pacific covers China, Indonesia, Korea, Malaysia, Philippines, and Thailand.

licenses to the private sector and a number of build-operate-transfer projects (BOTs) in electricity. Finally, a new banking law was passed in 2003, giving the central bank greater independence to target inflation.

Despite the reforms, the Egyptian economy performed below its potential. Economic growth fell below 4 percent, unemployment rose to about 10 percent, and the ratio of exports to GDP did not exceed 10 percent. At the same time, the budget deficit grew to about 6 percent of GDP, exchange rate divergence continued, and antiexport bias persisted.[6] The cost of conducting business remained relatively high compared with other emerging markets. And the education system continued to produce a mix and quality of graduates unsuited to labor-market demand. There was room for improvement in infrastructure and banking, especially regarding competition, regulatory enforcement, and privatization.

With the appointment of a new cabinet in July 2004, the reform process picked up steam. At least three key initiatives are worth noting. The first is a major trade liberalization, which reduced the weighted average tariff rate from 14 to 9 percent and the number of tariff bands from 27 to 6. This was coupled with the abolishment of the 3 to 4 percent additional fees imposed earlier on imports. The second major reform concerns the income tax bill presented to Parliament in the second half of 2004. The draft law reduces the maximum rate to 20 percent, down from 42 percent for services and 34 percent for industry. Equally important, it contains elements for streamlining tax administration, including random inspection of tax returns and phasing out tax exemptions. Other reforms are under consideration: reactivation of the privatization program, financial-sector reform, and measures to further improve Egypt's business environment.

Overall, Egypt has made significant headway on reform. However, the remaining agenda is extensive if Egypt is to create sufficient jobs for new entrants into the labor market and improve the standard of living for all Egyptians. An FTA between the United States and Egypt could be an important anchor for some of these reforms.

Diversion Avoidance Effect

Beside the potential positive spillover effect at the regional level, and the benefit of boosting economic reform in Egypt, an FTA between the United States and Egypt would prevent US exporters and investors from being at a disadvantage in the Egyptian market, especially compared with the European Union. Egypt's association agreement with the European Union will eliminate tariffs on EU exports within 12 years. Without a

6. The antiexport bias was traced to an overvalued exchange rate, high level of tariffs on imports (an average of 21 percent), high corporate tax rate, and high real interest rate (Galal and Fawzy 2002).

similar agreement with the United States, US exports will be seriously penalized.

The magnitude of trade diversion for the United States may not be significant considering the size of the US economy, but it is not negligible either.[7] This is because the European Union and the United States are Egypt's most important trading partners. During fiscal 1991–2003, the European Union and the United States averaged 39 and 23 percent of Egypt's imports and 33 and 31 percent of its total exports, respectively—and Egyptian imports from the European Union and the United States are close substitutes. Reinforcing both factors is the plan to reduce US economic aid to Egypt over time, which has so far been tied to imports from the United States. The elimination of tariffs on EU imports but not US imports will substantially reduce US exports to Egypt. An FTA with the United States may avert or at least lessen these effects.

Sustainability of Bilateral Economic Relations

The economic relationship between Egypt and the United States is important to both countries, but it is also asymmetric, since Egypt is a much smaller economy. It encompasses trade in goods and services, capital inflows, and significant transfers of aid to Egypt. It is also marked by some distinct features, reflecting the fact that the two countries' economic interaction is concentrated in a few activities. Overall, the United States runs a substantial trade surplus, which is offset by US expenditures on economic and military assistance. The Egyptian presence in the US market is limited and, aside from petroleum, heavily concentrated in exports of textiles and apparel, which are subject to relatively high tariffs. Although US exporters are constrained by many aspects of Egypt's trade and regulatory environment, the United States has been able to export grains, arms, and specialized equipment fairly successfully. Outside of petroleum, US investment in Egypt is very small.

Trade

The United States is Egypt's second major trading partner. From 1996 to 2004, US exports to Egypt averaged $3.2 billion and constituted about a fifth of Egypt's imports of merchandise, a share exceeded only by the European Union collectively (see table 2.2 for Egyptian imports from the United States in 2004). Egypt's merchandise exports to the United States have generally been modest, averaging just $946.6 million between 1996 and 2004 (see table 2.3 for Egyptian exports to the United States in 2004).

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7. See chapter 4 of this study for estimates.

Table 2.2 Egyptian imports from the United States and applied tariffs, 2004

HS classification	Import sector	Value of imports (millions of dollars)	Tariff rates (percent, simple average)
10	Cereals	808.1	3.3
84	Nuclear reactors, boilers, machinery, mechanical appliances, and parts thereof	508.3	5.5
88	Aircraft, spacecraft, and parts thereof	232.1	5.0
87	Vehicles other than railway or tramway rolling stock, and parts and accessories thereof	227.5	23.9
93	Arms and ammunition and parts and accessories thereof	217.7	21.0
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television recorders and reproducers, and parts and accessories thereof	154.5	10.1
39	Plastics and articles thereof	96.3	10.2
90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus, and parts and accessories thereof	95.8	6.0
27	Mineral fuels, mineral oils and products of their distillation, bituminous substances, and mineral waxes	76.2	6.4
29	Organic chemicals	47.2	2.0
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds and fruits; industrial or medicinal plants; straw and fodder	47.1	2.9
98	Special classification provisions, nesoi	40.7	
73	Articles of iron or steel	39.8	15.5
48	Paper and paperboard; articles of paper pulp, paper, or paperboard	32.6	13.4
23	Residues and waste from food industries; prepared animal feed	30.7	4.5
83	Miscellaneous articles of base metal	28.4	16.6
30	Pharmaceutical products	28.1	6.2
38	Miscellaneous chemical products	24.7	6.5
47	Pulp of wood or other fibrous cellulosic material; recovered (waste and scrap) paper and paperboard	16.3	2.0

(table continues next page)

Table 2.2 *(continued)*

HS classi-fication	Import sector	Value of imports (millions of dollars)	Tariff rates (percent, simple average)
35	Albuminoidal substances, modified starches, glues, and enzymes	15.5	8.4
72	Iron and steel	14.7	6.8
15	Animal or vegetable fats and oils and their cleavage products, prepared edible fats, and animal or vegetable waxes	14.0	7.2
32	Tanning or dyeing extracts; tannins and derivatives; dyes, pigments, and other coloring matter; paints and varnishes; putty and other mastics; inks	13.0	5.7
4	Dairy produce; birds' eggs; natural honey; edible products of animal origin, nesoi	11.7	11.4
44	Wood and articles of wood; wood charcoal	10.7	12.4
89	Ships, boats, and floating structures	10.4	3.0
49	Printed books, newspapers, pictures, and other printed products; manuscripts, typescripts, and plans	10.0	11.3
94	Furniture; bedding, cushions, etc.; lamps and lighting fittings, nesoi; illuminated signs, name-plates, and the like; prefabricated buildings	9.0	27.3
70	Glass and glassware	8.5	13.6
28	Inorganic chemicals; organic or inorganic compounds of precious metals, of rare-earth metals, of radioactive elements, or of isotopes	8.2	2.1
34	Soap etc.; lubricating products; waxes, polishing, or scouring products; candles etc., modeling pastes; dental waxes and dental plaster preparations	7.4	13.4
	Others	82.0	
	Total imports	**2,967.2**	

nesoi = not elsewhere specified or included

Sources: USITC (2002) and authors' calculations based on Egypt's applied tariff schedule.

Table 2.3 Egyptian exports to the United States and MFN ad valorem tariff rates in the US market, 2004

HS classification	Export sector	Value of exports (millions of dollars)	Tariff rates (percent, simple average)
27	Mineral fuels, mineral oils, and products of their distillation; bituminous substances; mineral waxes	261.6	1.3
72	Iron and steel	254.4	0.3
62	Articles of apparel and clothing accessories, not knitted or crocheted	252.9	10.7
61	Articles of apparel and clothing accessories, knitted or crocheted	169.3	11.7
98	Special classification provisions nesoi	96.3	0.4
57	Carpets and other textile floor coverings	69.3	2.8
63	Made-up textile articles nesoi; needlecraft sets; worn clothing and worn textile articles; rags	42.9	6.7
52	Cotton, including yarns and woven fabrics thereof	35.3	8.6
25	Salt; sulfur; earths and stone; plastering materials, lime and cement	20.6	0.3
94	Furniture; bedding, cushions, etc.; lamps and lighting fittings nesoi; illuminated signs, name-plates, and the like; prefabricated buildings	19.4	2.3
31	Fertilizers	13.7	0.0
76	Aluminum and articles thereof	11.8	3.7
97	Works of art, collectors' pieces, and antiques	8.5	0.0
68	Articles of stone, plaster, cement, asbestos, mica, or similar materials	6.5	1.8
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds, and fruits; industrial or medicinal plants; straw and fodder	6.4	8.2
59	Impregnated, coated, covered, or laminated textile fabrics; textile articles suitable for industrial use	6.2	3.1
99	Special import reporting provisions nesoi	4.9	48.2
7	Edible vegetables and certain roots and tubers	4.6	9.0
20	Preparations of vegetables, fruit, nuts, or other parts of plants	3.6	10.9
84	Nuclear reactors, boilers, machinery, mechanical appliances, and parts thereof	3.0	1.3
9	Coffee, tea, mate, and spices	2.8	0.7

(table continues next page)

Table 2.3 *(continued)*

HS classi-fication	Export sector	Value of exports (millions of dollars)	Tariff rates (percent, simple average)
33	Essential oils and resinoids; perfumery, cosmetic, or toilet preparations	2.8	1.3
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television recorders and reproducers, and parts and accessories	2.8	2.0
22	Beverages, spirits, and vinegar	2.6	1.8
54	Manmade filaments, including yarns and woven fabrics thereof	2.6	10.4
28	Inorganic chemicals; organic or inorganic compounds of precious metals, of rare-earth metals, of radioactive elements, or of isotopes	2.6	2.5
64	Footwear, gaiters, and the like, and parts thereof	2.3	15.6
	Others	20.2	
	Total exports	**1,330.0**	

nesoi = not elsewhere specified or included

MFN = most favored nation

Source: USITC (2002).

Although these exports represent about 10 percent of Egypt's total exports, they constitute less than one-tenth of 1 percent of all US imports, placing Egypt far down the ranks of US suppliers.[8] The size of the bilateral trade balance is insignificant for an economy the size of the United States' but on average has equaled almost half of Egypt's total exports of merchandise.

The composition of trade between Egypt and the United States shows a high degree of concentration. Between 2000 and 2004, according to USITC data, US exports to Egypt centered on cereals (24.9 percent of the total), aircraft and parts (16.2 percent), nuclear reactors (13.6 percent), vehicles (7.4 percent), electrical machinery (5.5 percent), and arms (4.7 percent). Egypt is actually the largest importer of US wheat worldwide (USTR 2003, 97). The main Egyptian exports to the United States over

8. In 2002, special exports (ancient Egyptian treasures for exhibition) of $415 million boosted Egyptian exports to the United States to $1.34 billion.

the same period were clothing and textiles (47.3 percent) and mineral fuel oil and its distilled products (16.5 percent). When special exports (14.7 percent) are excluded, these two categories comprised 75 percent of all Egyptian exports to the United States.

The past seven years have been a period of strong economic growth in imports for the United States generally. Between 1996 and 2002, the value of US merchandise imports increased by about 50 percent. Yet in 2002, excluding a surge of imports of historic treasures, which will be returned to Egypt, US imports from Egypt stood at virtually the same level as in 1996, suggesting an erosion in the relative competitiveness of Egyptian products in the US market. A US-Egypt FTA could change that.

Foreign Direct Investment

Egypt has seen low levels of US FDI compared with other countries. In 2001, US nonbank foreign affiliates in Egypt had assets valued at $7.2 billion and employed 32,400 workers (BEA 2003, 99). Although quite similar to Turkey, where US foreign affiliates had assets of $7.1 billion and employed 38,900 workers, this level of investment is relatively modest compared with US FDI in Latin America and East Asia. Colombia's GDP in 1999 was $238 billion (PPP) compared with Egypt's $214.3 billion, yet the value of assets of nonbank foreign affiliates in Colombia was $13.37 billion. Malaysia's GDP in 1999 was $186.4 billion, yet investment there was $27.6 billion.

Meanwhile, US FDI that does go to Egypt is highly concentrated in the oil sector—75 percent of it compared with only 21 percent in manufacturing. In contrast, the manufacturing sectors in Israel and Turkey received 68 percent and 54 percent respectively of total US FDI (US Department of State 2002). The low level of US FDI in Egypt and its concentration in the oil sector may be attributed to the limited attractiveness of the Egyptian economy compared with investment opportunities in the Far East and Latin America. A US-Egypt FTA might make Egypt a more inviting place to invest.

Aid

US aid to Egypt has been the most significant component of economic relations between the two countries since 1979. According to the US State Department (USAID 2005), "In 1979, following the Camp David Accords, Egypt became the beneficiary of one of the largest US economic assistance programs in the world." From 1975 to 2003, the US Congress allocated approximately $815 million annually to Egypt, or about $25.5 billion in total, aimed at enhancing stability, democracy, and prosperity in Egypt and the region.

These funds have undoubtedly helped relax the foreign exchange constraints facing the Egyptian economy. Even the funds earmarked for military expenditure benefited the economy, since Egypt would have had to raise them, or a fraction of them, internally or externally. Aid has contributed to the expansion of infrastructure and helped support policy and institutional reforms toward a more market-oriented and private sector–led economy, although some argue that aid may also give policymakers a cushion to delay essential reforms. Krueger (1997) argues that Korea began its reform process in the early 1960s only when the United States threatened to stop the flow of aid. Others, such as Burnside and Dollar (1997), 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 economic aid to Egypt is uncertain. According to the State Department, "Consistent with the US Government (USG) shifting the focus of its development assistance from aid to trade in Egypt, the USG and the Government of Egypt agreed that the United States would reduce economic assistance to Egypt by an average of 5 percent annually (approximately $40 million/year) during the FY2000–2009 period. Thus, USAID provided economic assistance to Egypt in the amount of $735 million in 2000, $695 million in 2001, and $655 million in 2002. In 2003, USAID will provide $615 million. By the end of the 10-year period in 2009, USAID's annual assistance level will be approximately $400 million."

While reductions in economic assistance to Egypt appear to be proceeding as planned, the trade agreement component of the approach has not been forthcoming. To be sure, Egypt has continued to receive significant amounts of assistance, but it has been ad hoc rather than strategic. In 2003, the United States offered Egypt up to $2.3 billion in grants, loans, and other assistance to help it deal with the economic impact of the war in Iraq.[9] An FTA could provide a framework for US-Egypt relations in trade and aid, making US economic policies toward Egypt more predictable and comprehensible, and thus making the relationship between them more stable.

Conclusion

An FTA between Egypt and the United States holds the promise of political and economic benefits for both parties. For Egypt, it could support domestic reforms, enhance access to the US markets, and mobilize higher

9. Egypt could also be eligible for assistance under the Millennium Challenge Account, which provides development aid to low-income countries that adopt economic and political reforms.

levels of foreign investment. It could also render economic relations with the United States more sustainable, moving away from aid to trade. For the United States, an FTA could eliminate the disadvantages faced by US exporters and investors in Egypt as a result of the EU association agreement and GAFTA. In addition, the success of economic reform in Egypt could have positive spillover effects throughout the Middle East. Much depends, however, on what the specific terms of the FTA would be—as the next chapter will discuss.