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U.S.-Egyptian Economic Relations: Aid, Trade, and Reform Proposals

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Summary

This report analyzes U.S.-Egyptian economic relations in light of renewed attention concerning Egypt's human rights and democratization record. In the past year, the Egyptian government imprisoned the 2005 presidential election runner-up, Ayman Nour, on fraud charges and arrested non-violent protestors, judges, and journalists. In response, the Administration and Congress halted plans to negotiate a U.S.-Egyptian Free Trade Agreement (FTA). There also were several proposals in Congress to reduce aid to Egypt. For additional information, see CRS Report RL33003, *Egypt: Background and U.S. Relations*. This report will be updated as events warrant.

Overview of U.S.-Egyptian Relations

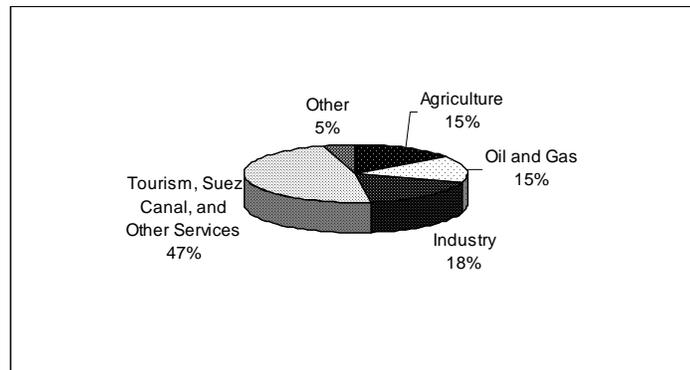
Since the Camp David Accords of 1979, the United States and Egypt have cooperated to stabilize the Middle East, advance the Arab-Israeli peace process, and fight terrorism. The United States values Egypt's moderating, influential position in the region. Economic relations between the two countries are rooted in their strategic ties. For example, U.S. foreign aid to Egypt historically has rewarded Egypt for maintaining peace with Israel. To strengthen Egypt's capacity to support U.S. interests, the United States has called for economic reform in Egypt, most recently in the financial sector. Despite significant reforms undertaken by the Egyptian government, the Administration and Congress have reevaluated plans to expand economic cooperation with Egypt due to the Egyptian government's poor human rights and democracy record.

Snapshot of Egypt's Economy

With over 77.5 million people, Egypt has the largest population and consumer market in the Arab world and the second largest gross domestic product (GDP) after Saudi Arabia. Annual GDP growth is about 5% due to high oil prices and renewed

confidence in the government.¹ The services sector drives the economy, but is highly susceptible to external shocks. For instance, the tourism industry suffered a heavy blow following the terrorist attack in Luxor in 1997, but recovered quickly from suicide bombings at Egyptian resort areas in 2005-2006. The energy sector's importance increases as Egypt expands natural gas production. The agriculture sector is the largest employer of the economy (one-third of the workforce), but its contribution to the GDP is declining due to urbanization and erosion in the fertile Nile Valley.

Figure 1. Egyptian GDP by Sector



Source: The Economist Intelligence Unit and Organization for Economic Cooperation and Development.

Market liberalization efforts have increased foreign investment levels in Egypt. The United States holds the largest stock of foreign direct investment (FDI) (\$4.2 billion in 2004), which is concentrated in the energy sector. Egypt's largest foreign investor is the Houston-based Apache Oil Company (more than \$2.5 billion as of December 2004). U.S. firms also invest in banking and manufacturing industries. In spite of improvements in business conditions, foreign firms still face red tape, widespread corruption, high health and safety standards, and an unresponsive commercial court system.²

Lack of economic opportunity is a source of popular frustration. Unemployment officially is close to 10%, but various independent estimates are as high as 20%. Job creation has not kept pace with Egypt's high population growth rate. The educational system also is inadequate to meet the needs of the burgeoning youth population. Poverty is another serious problem; about 40% of Egyptians live on less than \$2 a day. Widespread political corruption impedes economic development in Egypt. Funds lost through corruption are not reinvested into the economy to create jobs or spent on public health, education, or social programs.

Economic Reforms in Egypt

Egypt's transition from a state-controlled economy to a market economy driven by the public sector began in 1974, with President Anwar Sadat's Open Door Policy (*intifah*). After decades of setbacks, economic reform efforts were reinvigorated in July

¹ The Economic Intelligence Unit, "Country Report: Egypt," February 2006.

² U.S. Trade Representative, "2006 National Trade Estimate Report on Foreign Trade Barriers."

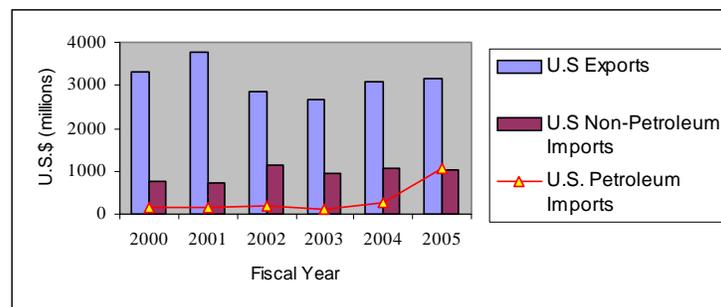
2004 under a new Cabinet team of liberal-minded economic reformists allied with Gamal Mubarak, the 42-year-old son and possible successor of President Hosni Mubarak.

Recent economic reforms include strengthening fiscal policy, privatization, and trade liberalization. Based on government consultations with the International Monetary Fund (IMF), Egypt committed to reducing its budget deficit through fiscal restraint in 2005. The government reduced energy subsidies, but faces enormous political resistance to trimming public subsidies on bread, sugar, and cooking oil, which cushion the impact of economic downturns on Egypt's poor. Egypt also reinvigorated its privatization program to attract foreign investment, allocate resources more efficiently, and increase external competitiveness. Significant shares of the state-owned Suez Cement Company and joint ventures in the energy sector have been sold. The government divested shares in the state-dominated banking and insurance sectors as well. Privatization efforts have stalled recently due to disagreements about labor issues and concerns about the impact of privatization on unemployment and the price of goods. Additionally, the government removed import service fees and surcharges and reduced the average weighted rate for tariffs in September 2004. In the past few years, the government liberalized the telecommunications sector, but significant trade barriers remain in the service sector.

U.S.-Egyptian Trade Relations

The United States is Egypt's second most important bilateral trading partner, while the European Union is the largest. Egypt is the United States's 54th largest trading partner. However, Egypt is the largest market for American wheat, as well as a significant importer of other U.S. agricultural goods, machinery, and equipment. Egyptian exports to the United States include clothing, textiles, and petroleum products. The United States has a trade surplus with Egypt, standing at \$1.1 billion in 2005.

Figure 2. U.S.-Egyptian Trade



Source: American Chamber of Commerce in Egypt.

Since the mid-1990s, Egypt has sought to negotiate an FTA with the United States. The FTA is viewed by Egypt as a means to increase employment opportunities and foreign investment. From the perspective of U.S. interests, the FTA could enhance access to Egypt's market for industries such as agriculture and services.³ It also could strengthen U.S.-Egyptian relations; affirm U.S. commitment to economic development in the region; and, most importantly, facilitate the Administration's proposal to create a Middle East

³ Ahmed Galal and Robert Z. Lawrence, "Anchoring Reform with a US-Egypt Free Trade Agreement," Institute for International Economics, May 2005.

Free Trade Area (MEFTA) by 2013. The United States already has FTAs with Israel, Jordan, Oman, Morocco, and Bahrain. On the other hand, there is some concern, particularly among U.S. manufacturers, that a U.S.-Egyptian FTA would affect the U.S. textile industry adversely.

In 1999, Egypt and the United States signed a Trade and Investment Framework Agreement (TIFA) to promote discussion on bilateral trade and investment issues. Intellectual property rights (IPR) protection was a contentious issue in pre-FTA negotiations held under the TIFA. The U.S. Trade Representative (USTR) placed Egypt on its 2006 Special 301 Priority Watch List due to Egypt's inadequate IPR enforcement and issuance of market approvals for unauthorized pharmaceutical products. Progress toward FTA negotiations continued until early 2006, but was then halted by the United States reportedly in protest against the imprisonment of Ayman Nour, the runner-up to the 2005 presidential elections.⁴ Few observers expect that discussions will resume before the President's Trade Promotion Authority expires in July 2007.

Some analysts believe that the postponement of FTA talks upset Egypt, which pursued economic reforms, in part, to increase U.S. willingness to engage in negotiations. Egypt also felt that the United States should reward Egypt's cooperation in the war on terror and ongoing efforts to promote peace in the Middle East through an FTA. There is concern that the postponement may decrease momentum for continued economic reform in Egypt. Other commentators suggest that the delay will galvanize Egyptian authorities to push ahead with economic reforms. Under this view, the reforms are both a key to Egypt's economic interests and a means to obtain an FTA eventually.

There is speculation by some analysts that the delay may weaken U.S.-Egyptian commercial ties as Egypt seeks other trade opportunities, for instance through the 2001 Euro-Mediterranean Association Agreement.⁵ Others counter that Egypt already has open access to U.S. markets for some goods through the Qualifying Industrial Zones (QIZ) program, which permits Egyptian industrial products with specified amounts of inputs from Israel to enter the United States duty-free and without quotas. Egypt initially resisted participation in QIZ, hopeful of a U.S.-Egyptian FTA instead, but reversed its position in 2004 because of the approaching expiration of the World Trade Organization Multi-fiber Agreement, which threatened to crowd out Egyptian textile exports to the United States due to a flood of similar, less expensive goods from China and India. In 2005, products under the QIZ program represented 12% of Egypt's exports to the United States. Textiles and apparel constituted nearly all of Egypt's exports under QIZ.⁶

Conditioning U.S. Economic Aid to Egypt on Reform

The use of foreign assistance to support moderate Arab governments in promoting peace with Israel has long been a cornerstone of U.S. policy in the Middle East. Since 1979, Egypt has been the second largest recipient of U.S. foreign assistance after Israel,

⁴ Joel Brinkley, "Tying trade to democracy, U.S. holds off on talks with Egypt," *The New York Times*, January 18, 2006.

⁵ Oxford Analytica, "EGYPT: US Congress blocks Free Trade Agreement," June 16, 2006.

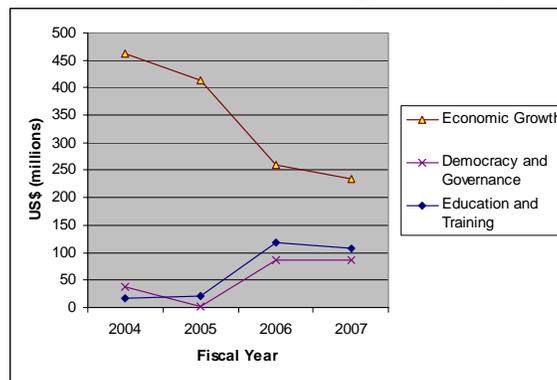
⁶ See CRS Report RS22002, *Qualifying Industrial Zones in Jordan and Egypt*, for more information.

receiving about \$2 billion annually. While the majority of U.S. foreign assistance to Egypt is directed toward military support, Egypt has received about \$30 billion in economic aid since 1979 from the Economic Support Fund (ESF), which is allocated to direct cash transfers to the Egyptian government, the Commodity Import Program (CIP), and development projects administered by the U.S. Agency for International Development (USAID). In 1998, the United States and Egypt agreed to reduce U.S. economic aid to Egypt by \$40 million increments annually until stabilizing at about \$400 million in 2008.

Congress generally earmarks aid for Egypt annually in the Foreign Operations Appropriations bill, with language noting that economic aid is conditioned on Egypt undertaking agreed-upon economic policy reforms. Most recently, the United States conditioned ESF assistance to Egypt on financial sector reform, based on a 2005 Memorandum of Understanding (MOU) between the two countries. In the MOU, Egypt agreed to financial sector reforms such as privatizing the banking system, conforming with international standards, strengthening transparency and accountability, and creating a functioning securities market and liquid mortgage market.⁷

Although ESF assistance is designed to target economic growth, the funds can also be used in other areas. Funding for economic growth still accounts for most of the ESF account, but its proportion declined from 81% in FY2004 to 52% in FY2007. In contrast, democracy and governance program funding is increasing from 6% in FY2004 to 19% proposed for FY2007. Similarly, funding for education and training programs also rose; 24% is recommended for FY2007, compared to 3% in FY2004.

Figure 3. Allocation of U.S. Economic Aid to Egypt (ESF)



Source: USAID Congressional Budget Justification, FY 2004-2007.

Generally, economic funds are given to Egypt when economic policy reforms are agreed upon or legislated, not when implemented. However, there has been some frustration over Egypt's failure to achieve economic reform benchmarks. Critics of U.S. economic assistance to Egypt suggest that the economic aid program has become an entitlement and advocate rescinding funds until economic reform projects actually are completed. Some advise that economic development is a slow process and encourage the Administration and Congress to continue exercising patience with Egypt.

⁷ U.S. Government and Government of Egypt, "Memorandum of Understanding: Support for the Egyptian Financial Sector," December 22, 2004.

Proposals to rescind economic funds to Egypt also may be in response to deep disappointment over recent setbacks in Egypt's democratization process. The slow overall pace of political reform in Egypt raises questions about the sincerity of the Mubarak government's pro-democracy stance. Some members of Congress suggest that rescinding economic aid would send a clear signal of U.S. dismay to Egypt without undermining Middle East peace process efforts. However, the Administration believes that rescinding aid may be deleterious to the United States' strategic relationship with Egypt and efforts to promote regional stability. Additionally, some development experts caution against politicizing economic aid because they believe it would hinder Egypt's progress toward economic reform.⁸ The Egyptian government opposes linking economic aid to political reform and is critical of U.S. funding for democracy and human rights programs operated by civil sector organizations without Egyptian government approval.

Recent Congressional Action

In May 2006, the House Appropriations Committee rejected an amendment to cut \$200 million in military aid to Egypt during markup of H.R. 5522, the FY2007 Foreign Operations Appropriations Bill. In June 2006, the House defeated an amendment (198-225) to H.R. 5522 that would have shifted \$100 million in economic aid for Egypt to fight AIDS worldwide and to assist the Darfur region of Sudan. Many supporters of the amendment were dismayed by the Egyptian government's spring 2006 crackdown on pro-democracy activists in Cairo. Representative David Obey of Wisconsin sponsored both amendments. As it currently stands, the House version of H.R. 5522 funds the President's full request for Egypt, but sets aside \$50 million for democracy and governance programming and \$50 million for education in Egypt. It also rescinds \$200 million in funds previously appropriated for cash assistance in FY2003-FY2006 due to insufficient financial sector reforms.

On June 29, 2006, the Senate Appropriations Committee also approved the Administration's request for Egypt. The Senate version rescinds \$300 million in previously appropriated but unspent economic aid to Egypt, \$100 million above the House recommendation. The accompanying Senate Committee Report to the bill (S.Rept. 109-277) expresses concern "with the lack of political reform in Egypt and the incarceration of secularist politicians, including Ayman Nour." The bill now faces Senate floor consideration.

Future Considerations

Egypt's progress in reforming its financial sector and improving its human rights and democratization record is likely to influence future prospects for FTA negotiations and U.S. economic aid to Egypt. External events also may impact economic relations between the two countries. The recent breakdown of the Doha Round, for example, could prompt Congress to shift more attention to the negotiation of bilateral FTAs with countries such as Egypt. Additionally, Egypt's role in the current Israeli-Lebanon crisis and other political situations in the Middle East may reaffirm the country's strategic importance to the United States and strengthen support for U.S. economic aid to Egypt.

⁸ CRS analyst interview with USAID official on July 17, 2006.