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The Euro-Mediterranean free trade agreement and the cost of tariff liberalization in Egypt

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Abstract

In this research, a regional intertemporal general equilibrium model is constructed to study the nature of the adjustment path to preferential trade liberalization between Egypt and the European Union. Aside from the dynamic gains from trade – higher growth and welfare – the Egyptian economy incurs adjustment costs along the transition to freer trade. However, these costs are relatively lower than those incurred under unilateral liberalization. Welfare is found to be higher if the implementation of the agreement is followed some time in the future with removing all remaining tariffs on imports originating from the rest of the world.

JEL classification: F13; F14; F16; F16

Keywords: Egypt; Preferential trade agreements; Adjustment costs; Intertemporal General Equilibrium Models

1. Introduction

In 2004, the association agreement between Egypt and the EU – Egypt's major trading partner (receiving 32% of all exports and providing 33% of all imports in 2010) – came into force as tariffs on intermediate and capital goods were gradually removed over the period 2004–2008 followed by a second phase whereby tariffs on both industrial and agricultural goods originating from the EU are to be removed gradually over the coming 8 years. While Egypt had historically enjoyed duty free access to industrial goods in the EU market way before the agreement was signed, significant reduction in non-trade barriers facing agricultural exports took place over the past few years and further reduction on this front is expected to take place in the future.

Trade liberalization whether taking place unilaterally or within the framework of preferential trade liberalization has been a very popular policy stance given the substantial gains static or

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dynamic (more technical progress as new ideas develop, higher productivity spurred by more intense competition, less corruption and thus higher rates of investment in both physical and human capital, etc.) as emphasized in a recent survey of the literature by Winters (2004). While the gains from trade liberalization in the context of the agreement either in terms of higher growth and investment flows as well as enhanced exports opportunities should – to a limited extent be now felt, it is not clear what the future holds for growth once tariffs on imports of industrial goods from the EU are removed. Meanwhile, the adjustment costs to trade liberalization – if any – are yet to materialize given that most of manufacturing industries continue to enjoy high rates of nominal protection via tariffs and thus high rates of effective protection given the falling tariffs on intermediate and capital goods.

Empirical studies of trade liberalization have demonstrated that the transitional costs to trade liberalization typically arise over the short run and are basically manifested in rising unemployment rates, balance of payment problems, declining industrial output (Michaely, Papageorgiou, & Choksi, 1991). The magnitude of these costs can be considerably high as documented by several recent studies (Artuc & Mclaren, 2010; Casacuberta & Gandelman, 2010; Davidson & Matuz, 2010; Elshennawy, 2011). For example, according, to Davidson and Matuz (2010), these costs are estimated to range from one third to 80% of the gross benefits of trade.

Imperfections in labor, capital and output markets are considered to be the primary factors leading to high adjustment costs. These costs are often the cause of the reversal of many trade liberalization attempts (Michaely et al., 1991). It is imperative to note that the possibility that such costs may materialize can deter policy makers from embarking on trade reform in the first place. This was also one of the reasons tariffs on imports from the EU are to be gradually removed.

With the aid of an Intertemporal General Equilibrium Model, a recent study by Elshennawy (2011), revealed that the transitional costs to free trade in the case of Egypt are quite significant which immediately raises questions about the magnitude of these costs in the case of trade liberalization within the context of the association agreement between Egypt and the EU. In general, it is important to note that the adjustment process to trade liberalization, a process which is inherently dynamic in nature has not been adequately treated in the theoretical and empirical literature concerned with preferential trade liberalization. In particular, whether the transitional costs associated with preferential liberalization are *higher* or *lower* than those associated with unilateral liberalization remains a viable question without an answer. On first insight, since preferential trade can be – and is usually – considered as a gradual move towards freer trade, it could be the case that the transitional costs involved turn out to be smaller in magnitude compared to unilateral liberalization. This could in principle provide an important *nontraditional* reason for why countries should seek to engage in preferential trade liberalization as a preliminary stage that lays the ground for further unilateral liberalization.

Gradualism in reducing trade barriers as described in the context of this research – that is preferential trade liberalization followed by unilateral complete removal of trade barriers across all trading partners – is in fact directly relevant to the question of how best to liberalize trade in the presence of adjustment costs. When it comes to how best to liberalize trade, so far, two main approaches are identified in the literature. According to the first, gradualism involves removing quantitative restrictions – if any – first and then tariff barriers in a later stage while the second involves gradual reduction of tariff barriers over time. The evidence that the first approach minimizes adjustment costs is based on the experience of several countries as documented in a World Bank 1991 study while the evidence regarding the second remains largely theoretical (see Furusawa and Lai, 1999). The exception is one empirical study by Elshennawy (2011) which revealed that gradual reduction of tariffs reduces investment over the transition to free trade and