MERIA

THE POLITICAL ECONOMY OF THE EGYPTIAN-ISRAELI QIZ TRADE AGREEMENT

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The Qualifying Industrial Zones (QIZ) Agreement signed in 2004 allows Egypt to gain non-reciprocal, duty-free access to U.S. markets for products containing at least 11.7 percent Egyptian and 11.7 percent Israeli components. This paper argues that the political achievements and economic gains from the QIZ Agreement will be limited. The Egyptian government views the QIZ as a quick fix to prevent job-shedding in the textile sector and as a stepping stone to a direct bilateral trade agreement with the United States. However, U.S. mistrust about Egypt's law enforcement regime and skepticism about broader political trends within Egypt has delayed the start of negotiations for a U.S.-Egypt agreement. Moreover, the Bush Administration's plan to create a Middle East Free Trade Area (MEFTA) by 2013 will gradually undermine the QIZ framework and divert investment toward countries that achieve bilateral preferential agreements with the United States. Israel views the agreement primarily in political terms. Although the QIZ provides a modest boost in exports and a chance to salvage market share in a labor-intensive industry, it mainly functions to remove the Arab "taboo" against conducting business openly with Israeli firms. Persistent political tensions in the region will discourage Israel from expanding the scope of investments in Egypt.

INTRODUCTION

On December 14, 2004, Egypt signed a landmark trade agreement with Israel. Although the U.S. Trade Representative presided over the signing ceremonies, the negotiations had been essentially bilateral in character.[1] The Qualifying Industrial Zones (QIZ) Agreement allows Egypt to gain non-reciprocal, duty-free access to U.S. markets for products containing at least 11.7 percent Egyptian and 11.7 percent Israeli components.

For the Egyptian government, the agreement came just in time, ahead of a World Trade Organization (WTO) mandated liberalization of the textile quota system. The termination of the 30-year-old quota system meant that Egypt faced the prospect of duties as high as 35 percent in certain textile manufactures in the place of generous bilateral agreements with trade partners in the industrialized countries. With 150,000 jobs in the private sector textile industry—which represent nearly 27 percent of industrial production and 25 percent of manufacturing employment in Egypt—on the line and $558.3 million in exports (or over 10 percent of non-oil exports) at stake, Egypt had little alternative but to sign.[2] In essence, Egypt was motivated to sign the QIZ Agreement out of fears of a genuine opening of the global trading system to comparative advantage.[3]

Although the agreement sparked heated debate in the Egyptian parliament with 3,000 demands for official explanations, President Husni Mubarak effectively muted parliamentary objections when he personally vouched for the protocol. Moreover, Egypt's mufti, Ali Jum'a, declared that the agreement was acceptable under Islamic Law.[4] Most surprisingly, however, the initial street protests in Egypt by unionized workers called for the *expansion* of the number of zones in the agreement. While politicians, students, and intellectuals remain hostile to the agreement and "normalization"[5] of relations with Israel, Egyptian labor leaders clearly viewed the agreement as a mechanism to save jobs in an endangered industry.

The strongest backing for the QIZ Agreement came from Egypt and Israel's business communities, which had prodded their governments into the negotiations in the first place. In fact, the negotiations had begun as a private sector initiative with the blessing of President Husni Mubarak but without official state involvement,[6] until Israeli businessmen insisted that any agreement have the "umbrella" of support from both governments.[7]

Currently 655 companies, mainly textile factories, have qualified to participate in the QIZ and several new sites have been incorporated or expanded.[8] In the first four quarters after the agreement came into force, Egypt claimed nearly $406.6 million in QIZ related exports and $49 million in imports from Israel (see Chart 1).

Although the initial trade statistics seem impressive, it is important to place these figures in a broader historical context:

> Between 1994 and 2000, the total level of exports from Israel to Egypt was valued at $181 million. In 2000, the Israeli exports to Egypt were valued at $58.1 million. In 2001, Israeli products were exported to Egypt, with a total value of $47.1 million (a drop of 20 percent). Around half of the exports to Egypt were textile products. The remaining exports included chemical products, fertilizers and oil products. Israeli products accounted for around 0.3 percent of the overall Egyptian imports for the year 2000.
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> Between 1994 and 2000, the imports from Egypt to Israel reached a total of $1.606 billion. In 2001, Egypt [exported] goods (excluding oil and services) to Israel with a total value of $20 million, in comparison to a total of $20.7 million for 2000.[9]

While the trade statistics supplied to the United Nations by Israel and Egypt are irreconcilable, the Egyptians reported even higher levels of bilateral trade with Israel from 1994 to 2000.[10] By all accounts trade between Egypt and Israel began to decline after September 2000 with the eruption of hostilities between Israelis and Palestinians. Accordingly, the QIZ Agreement of 2004 may be interpreted as revitalizing a bilateral trade relationship that had been dwindling since the second intifada, while also providing a new channel for Egyptian exports targeted toward the U.S. market.

Although Egypt had to be prodded into reviving its trade ties with Israel by a combination of domestic interest-group pressure, global economic threats, and market access incentives, the Egyptian government quickly came to see the agreement as a political and economic "stepping stone" to a bilateral preferential trade agreement (PTA) with the United States. Strengthening social and political relations with Israel was never an important objective.

For the Israeli government, which already had a bilateral PTA with the United States, the objective from the agreement was more political than economic. Politically, the public signing of the agreement permitted Israel to begin removing the Arab "taboo" of doing business with Israel in the open. At the time, the agreement was part of a broader attempt to break out of its political and economic isolation in the region. Of course, Israel also gained from a small boost in its exports to Egypt (see Chart 3).[11]

The American government viewed the agreement from two perspectives. Publicly, the United States saw the QIZ Agreement as part of a broad, long-term economic and political strategy in the Middle East. Reinforced by the recommendations of the *9/11 Commission Report*, the Bush Administration sought to promote a Middle East that "trades in freedom."[12] The United States hoped that the QIZ Agreement would encourage Egypt to liberalize its economy and integrate economically with its neighbors and the global economy.[13] Privately, American trade negotiators hoped to keep the agreement limited in order to prevent alarming Congress.[14] However, since Egypt had been unable to fill its textile quota allotment under the previous Multi-Fiber Agreement regime, the fear of a flood of imports from Egypt remained very low. A bilateral PTA between the United States and Egypt would require separate negotiations. In essence, U.S. negotiators did not view the QIZ as a short-cut to a bilateral agreement with Egypt.

This paper argues that because of differing expectations among the signatories, as well as strong constraints within the context of regional trade relations, the economic and political gains from the QIZ Agreement will be modest for all parties involved. The first section of the paper situates the QIZ concept within the broader category of PTAs. The second section sketches the history of the QIZ Agreement as applied in Jordan and Egypt. The third section explains why the agreement will have only a limited political and economic impact. The final section summarizes why the QIZ Agreement is neither a strategy for export-led growth nor an economic "road map to peace" in the region without greater leadership from the Egyptian government.

PREFERENTIAL AND FREE TRADE

In 1996, the U.S. Congress passed legislation amending the 1985 U.S.-Israel Free Trade Implementation Act[15] to allow goods produced in "the West Bank and Gaza Strip or a qualifying industrial zone" to also be eligible for duty-free access to the United States.[16] Therefore, the QIZ Agreement is essentially a spatial extension of the bilateral PTA between Israel and the United States. A qualifying industrial zone is a site of production that legally functions as a part of Israeli territory for the purposes of the U.S.-Israel trade agreement. Products produced within a qualifying zone receive the same zero-tariff rate and zero-quota restrictions from the United States as any other Israeli export to the United States.

When it was first created, the U.S.-Israel PTA was a rare departure from the open and non-discriminatory multilateral trade system endorsed by the United States since WWII.[17] In recent years, however there has been a significant increase in the number of PTAs that the United States is willing to support, particularly in the Middle East. PTAs are viewed as economic instruments to promote broader political objectives. For example, the original purpose of the U.S.-Israel agreement was to lend economic support to an important U.S. ally in the Middle East during the Cold War.

While a PTA is not necessarily contradictory to a liberal multilateral trade regime, it may still distort the advantages that flow from genuine free trade among nations. PTAs do not legally violate the multilateral GATT/WTO framework if the agreements provide zero tariffs between the parties and there is a definite schedule for implementation of the agreement.

Nevertheless, although a PTA encourages an increased volume of trade between partners, it may also be "trade diverting" as trade with third parties is sacrificed to take advantage of zero-tariff rates within the framework of the agreement.[18] For example, an American manufacturer may feel compelled to purchase expensive inputs from an Israeli firm rather than cheaper inputs from a Turkish firm in order to take advantage of the duty-free provisions of the U.S.-Israel PTA. While the customer benefits from lower priced goods, a PTA may encourage inefficiency and delay the discovery of a natural comparative advantage. It is for this reason that PTAs are best viewed through a political rather than an economic lens.

The QIZ concept must not be confused with the concept of a Special Economic Zone (SEZ). A SEZ provides manufacturers with tax incentives as well as relaxed labor and investment regulations to encourage export-oriented production from the host country. A SEZ does not secure market access for the products manufactured. A QIZ provides a direct duty-free "tunnel" from the host country (i.e., Jordan or Egypt) to the home country (i.e., the United States) in exchange for economic cooperation with a third party (i.e., Israel). The agreement is open in terms of the type of product produced in the qualified zones, but it has been dominated by the textile industry. The number of qualifying zones is based on negotiations, but it cannot apply to the entire country of the third party. A QIZ agreement does not have an expiration date, but it can be terminated or superseded like any other treaty arrangement between states. The agreement does not impose any long term commitments on the qualifying firms. This may encourage "footloose" industries to leave if similar political arrangements can be set up in rival states that have better business climates.

THE JORDANIAN MODEL

The QIZ Agreement was first offered to Egypt under the Clinton Administration as a mechanism to strengthen peace in the Middle East. However, the Egyptian government failed to show interest. Attention shifted to creating an agreement with Jordan once Dov Lautman, the founder and chairman of the Board of Directors of Delta Galil Industries Ltd., announced his intention to move some of his textile plants from Israel to Jordan. Negotiations began in November 1997 at the Doha Economic Conference to set up a zone near Irbid, Jordan. In March 1998, the U.S. trade representative, Charlene Barshefsky, officially inaugurated the U.S.-Israel-Jordan QIZ Agreement and acknowledged the role of private businessmen in advancing the agreement:

> We are living through difficult times in the peace process. However, we are fortunate to have visionaries like Omar Salah of Jordan and Dov Lautman of Israel, the businessmen who organized the Irbid park. They have not lost sight of the goal of peace and are working every day to make it a reality.
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> I am grateful to be able to contribute to their efforts by exercising the authority that has been given to me to designate the Irbid duty-free area as the first "Qualifying Industrial Zone."[19]

The involvement of prominent businessmen in stimulating the QIZ negotiations ensured that business concerns were at the forefront of the agreement.

The agreement provided duty-free access to U.S. markets without a reciprocal concession from the Jordanians. There were two methods for qualification. At first, products that had 35 percent of their appraised value derived from content produced in one of the zones, with one-third of the 35 percent from Israeli partners and one-third from Jordanian partners, were permitted. The remaining one-third could come from the United States, West Bank, Gaza, or Israel.[20] Later provisions allowed products that were composed of a minimum of 20 percent of the total cost of production from Jordan (12 percent) and Israel (eight percent). The rest of the components not designated by the agreement could come from any country. This fourth-party provision to the QIZ has stimulated investment from Asian textile manufacturers. For example, China has been a major investor in Jordan's QIZ since 1998.[21] The agreement established a committee of Jordanians and Israelis with American observers to determine and the eligibility and compliance of different companies.

The Jordan-Israel QIZ is often seen as forging new links between the two countries. However, in 1998 Omar Salah, the chairman of the Century Investment Group and an architect of the QIZ Agreement, estimated that: "At this point you could say 90 per cent of local textile operations are subcontracting for Israeli companies working with international buyers based in Israel."[22] In essence, the agreement effectively recognized and built upon trade links that already existed between Israel and Jordan in the textile industry. At the time of the initial agreement, Jordanian businessmen believed that the agreement would save jobs in the textile sector and improve Jordan's competitiveness relative to Egypt.

By 2005 Jordan's cumulative exports through the QIZ exceeded $1 billion, a dramatic increase from a base of $26 million in 1998.[23] More than 40,000 workers, about half of whom are Jordanian and half of whom are migrant Asian laborers, are employed in the zones.[24] Investment in the QIZ exceeded $100 billion in 2004, and it is expected to double when all projects are completed.[25] By most accounts, the QIZ has been highly successful for Jordan's economy. Nevertheless, the success of Jordan's QIZ will soon be overshadowed by the bilateral PTA between the United States and Jordan signed on October 24, 2000. At the time, the U.S.-Jordan PTA was only the third such agreement made by the United States and the first with an Arab country. The agreement will gradually eliminate virtually all tariff barriers in manufactured and agricultural products as it is phased in by 2010, making the QIZ redundant. Therefore, it is not surprising that Jordan's exports to Israel began to decline after peaking at $136.7 million in 2002 (see Chart 4). Moreover, while Jordan's imports from Israel have outstripped exports since 2003 (see Chart 6), Israeli textile shipments to Jordan declined in 2005 by eight percent, to $95 million, because of the new bilateral agreement.[26] By 2006, the number of Israeli exporters operating in Jordan dropped by one quarter.[27] Finally, as a percentage of Jordan's total trade, Jordan's trade with Israel has been on a downward trajectory in recent years (see Chart 4).

In recent months, the Jordanian QIZ has also been troubled by increasing complaints of poor working conditions. Protectionist American unions have used the violations of human rights to lobby for formal trade litigation even after Jordanian authorities closed five factories.[28]

The Egyptian QIZ is modeled on the Jordanian agreement. However, the Egyptians were not able to bargain as effectively as the Jordanians. In the Egyptian QIZ, 11.7 percent of inputs must be from Israel, whereas only eight percent of Israeli inputs are required in the Jordanian QIZ. The reason for the difference is mainly due to the weaker bargaining position of the Egyptians, who were facing a phase out of the GATT/WTO textile quota regime in 2004. Moreover, as one negotiator stated, there was "an opportunity cost" for not negotiating the agreement in 1996.[29]

The official negotiation rounds began in July 2003. Although the talks were spearheaded by state appointed negotiators, business elites played a major role behind the scenes. The Egyptian negotiating team was headed by Sa'id al-Bus, advisor to Egypt's Ministry of Foreign Trade, and Sayyid abul Kumsan, the director general of the Ministry of Foreign Trade. The Israeli team was led by Yair Shiran, deputy director of Israel's Foreign Trade Administration. Supporting roles were played by Gabi Bar and Ilan Baruch. Behind the scenes the major players were Galal Zorba, president of the Egyptian Federation of Industries, and his counterpart on the Israeli side, Danny Rushin.

Israeli negotiators were keen that the agreement be published and that the Egyptian public be well-informed about the agreement. Their political objective was to legitimate the business relations, some of which had existed for decades, between the citizens of the two peace partners. Securing the release of Azzam Azzam, an Arab-Israeli textile engineer who had been imprisoned in Egypt on espionage charges, was also an important issue for textile entrepreneurs, but it was not part of the formal agreement. Although certain prominent Israeli businessmen stood to benefit materially from the agreement, economic gains were not a major incentive for official Israeli negotiators. Israeli trade with Egypt and Jordan combined constitutes less than one percent of Israel's total trade (see Chart 3).

Egyptian negotiators were under pressure from their government to "fast track" the negotiations not only because of the impending changes in the WTO textile quota regime, but also because other states in the region were securing bilateral PTAs with the United States (see Table 1). In essence, Egyptians were motivated to negotiate in order to limit gains by regional and global economic rivals. Moreover, the Egyptian negotiators hoped that signing the agreement with Israel would place their country on the highway to a direct PTA with the United States on the Jordanian model. Thus, Egyptians were willing to bargain, even from a weakened position, because the agreement was regarded in instrumental terms.

Although the United States acted as a facilitator during the discussions, its relations with Egypt were seriously damaged just before the talks began by exogenous events. Prior to the start of the QIZ negotiations, Yousef Boutros-Ghali, Egypt's foreign trade minister, had promised to support the United States in its WTO case against the EU on genetically modified organisms. However, Boutros-Ghali was persuaded by the Egyptian Foreign Ministry to rescind his offer of support to the United States and shift it to the EU. Afterwards, the United States trade representative, Robert Zoellick, publicly expressed his dissatisfaction with the Egyptians and downgraded prospects for a bilateral agreement: "We see glimmers of light [in Egypt]… But I am not going to sugar-coat it for people. Egypt has some work to do. But this [an FTA] is not going to be handed to them just because Egypt is a big and important country."[30] The United States requested Boutros-Ghali be removed as the lead negotiator in the QIZ talks and indefinitely postponed beginning negotiations about a bilateral trade agreement. Three years later, the United States has yet to start talks on a bilateral trade agreement with Egypt. Signing the QIZ Agreement has not helped Egypt to win the confidence of America for a bilateral trade agreement. In the meantime, Jordan, Bahrain, Morocco, and Oman have signed bilateral agreements with the United States and the UAE has started the negotiation process.

Even if diplomatic distrust were not a factor, the United States has several complicated issues to negotiate with Egypt, particularly in the areas of intellectual property and agriculture protection.[31] Other issues on the table include Egypt's human rights record and the detention of a leading opposition political candidate. As the president's "fast track" authority expires in July 2007, time has essentially run out for negotiations. A bilateral free trade agreement is still possible after the expiration of "fast-track" authority, but it will require even greater political and economic concessions from Egypt to satisfy the U.S. Congress.

GREAT POTENTIAL, LIMITED IMPACT

The QIZ has the potential to serve as the basis for strengthening regional political and economic ties. However, the outcome in both political and economic spheres is likely to be limited.

The original 1996 QIZ Amendment had been specifically designed by the U.S. Congress to promote trade between Israel, the West Bank, and Gaza as a means of enhancing peace. However, the Palestinian issue was notably absent from the negotiations between Egypt and Israel. As Egypt often views itself as a "big brother" to the Palestinians, it was surprising that the West Bank and Gaza were not discussed. The reason for discarding the Palestinian issue was most likely because it would only further complicate negotiations for the Egyptians and the Israelis.[32] Nevertheless, the ability of the QIZ Agreement to promote regional peace and stability will be hampered if the economic situation among the Palestinians is ignored.

The Israelis did initially attempt to build upon the positive political climate created by the QIZ to warm its cold peace with Egypt. In June 2005, Ben Gurion University announced its intention to present an honorary doctorate to a leading Egyptian playwright, author, and poet, Ali Salem.[33] In response, the Egyptian government denied Salem a visa to travel to Israel at the Tab'a border checkpoint. Egyptian authorities claimed that Salem did not have the proper travel documents. The statement was not credible, as Salem had visited Israel ten times previously and as recently as six months prior to the ceremony. Ben Gurion University awarded the honorary doctorate, although Salem's chair was empty during the ceremony. The message from the Mubarak regime was clear: The QIZ was only for strengthening economic relations between businessmen; it would not be allowed to serve as the basis for strengthening social ties between the two societies.

The hostility toward strengthening social relations continues a strategy followed by Egypt since the Camp David Accords. In accordance with the peace treaty, Israel established the Israeli Academic Center in

Cairo; however, Egypt has not fulfilled its obligation to create an Egyptian Academic Center in Tel Aviv. Egypt is clearly not interested in intellectual, social, and cultural exchanges with Israel; the peace is only a mechanism for securing development assistance and military equipment from the United States and economic opportunities for elite businessmen.

An examination of the political economy of Egypt, particularly in comparison to Israel, illuminates the reasons why the agreement will have a limited economic impact. Comparing the two neighbors is difficult, because Israel is an advanced industrial economy and Egypt is a middle-income developing country. In fact, Israel's GDP is almost $30 billion greater than Egypt's (at current prices), while Israel's population is less than one-tenth that of Egypt. However, the main issue is not size or output, but capacity and compatibility—since trade agreements between advanced and developing economies (such as between the United States and Mexico) are increasingly common and arguably mutually beneficial.

First, the number of jobs created under the QIZ will not close Egypt's cumulative unemployment and underemployment gap. The QIZ Agreement was realistically expected to produce about 100,000 jobs once factories were established.[34] The actual economic impact of the QIZ on the Egyptian labor force is difficult to gauge. Egypt's textile sector, which consists of 1,500 firms, employs roughly 500,000 individuals and produces $3.2 billion worth of goods or 3.5 percent of the country's GDP.[35] However, only 655 firms, 516 of which are textile firms, qualified to participate in the QIZ in 2006 (see Table 2). Moreover, only a small number of the companies qualified to participate in the QIZ have actually exported products under the agreement. In the second quarter of 2006, the Egyptian government revealed that 137 companies exported products under the agreement.[36] The government did not release any data on the exporting companies or on the workers in those firms.

In fact, the Egyptian government has not released a detailed study of the impact of the QIZ on employment. In promoting the agreement, the Egyptian government had estimated that the QIZ would ultimately attract $5 billion in investment. They argued that "these investments can increase the growth rate and provide more job opportunities ($5 billion * 6 LE= 30 billion LE, and by dividing on the average cost of employment 100,000 LE) = 300,000 new job opportunity [sic]."[37] Data on current foreign direct investment (FDI) specifically for the QIZ is not available.

However, non-oil and gas FDI in all of Egypt was $1.65 billion in 2005.[38] Thus, the Egyptian government's estimates on job growth seem optimistic given the actual participation of Egyptian exporters under the QIZ and current levels of FDI.

Of course, it is certain that without the QIZ Agreement, the Egyptian textile industry would have suffered layoffs. After signing the QIZ Agreement, Egyptian textile exports to the United States increased by 5.3 percent, from $421.6 million in 2004 to $443.8 million in 2005.[39] Moreover, in the first nine months of 2006, textile exports under the QIZ had reached $464 million.[40] The modest increase in duty-free textile exports to the United States most likely corresponds to modest job creation in the textile sector.

Nevertheless, Egypt needs to create at least 300,000 per year to match its ever-growing workforce and needs an additional 500,000 jobs to overcome the gaps built up from the previous years.[41] These estimates are conservative, and they do not factor the peculiar character of Egypt's official employment statistics. The state bureaucracy and state-owned enterprises constitute one-third of total official employment.[42] As these jobs constitute a form of social welfare in Egypt, productivity is often extremely low with little contribution to overall national wealth. Jobs produced by the QIZ will not be sufficient to fill in the unemployment and underemployment gap.

Second, the QIZ Agreement does not redress the underlying causes of Egypt's uncompetitive industries. Although a capital injection and duty-free market access may temporarily revive the textile industry, painful structural changes are still necessary. The process of making an industry competitive is often long and painful. China's state-owned textile industry restructuring provides a relevant example:

> After 1949 the textile industry continued to be China's largest industry, employing 7.6 million workers at its peak in 1991. Beginning in the early 1990s the industry went into the red for the first time. In an effort to raise productivity and curtail financial losses, the industry began to shed workers. By 1996, employment in the industry had shrunk to 6.34 million. But the textile industry's losses had grown to RMB 9.6 billion, making it by far the biggest money-losing sector in state-owned manufacturing. The industry, long characterized by outdated equipment and high production costs, initiated a more radical restructuring beginning in 1998 in response to Premier Zhu Rongji's charge to cut losses of state-owned firms. The state closed more than 600 state-owned textile factories (one-fifth of the total), eliminated 9.4 million cotton spindles, and laid off an additional 1.4 million workers by the end of 2000. By 1999 state-owned textile companies recorded a slight profit of RMB 800-900 million, their first in seven years. In 2000 profits surged to RMB 6.7 billion.[43]

In sharp contrast to the Chinese approach, Egypt signed the QIZ Agreement to save jobs rather than endure the painful process of restructuring to increase productivity and competitiveness. The QIZ has bought Egypt time, but it has not obviated the need for reform. Egypt has made some halting steps toward privatization and structural adjustment since 1991; however, the overall results have been disappointing, as the state continues to be the dominant actor in all industries except cement, alcoholic beverages, and cellular telephones. Furthermore, the non-reciprocal character of the QIZ means that Egyptian firms will not have to face competition from American companies in exchange for access to U.S. markets. Instead of promoting adjustment, the QIZ postpones it.

Third, the dramatically different industrial character of the two countries limits prospects for close cooperation. Almost all of Israel's commodities exports are manufactured goods, compared to just over a quarter for Egypt. Petroleum and mining products constitute half of Egypt's exports. Israel is increasingly becoming a source for high-tech military equipment. The defense industry now constitutes 17 percent of non-diamond exports. In 2006, the Israeli defense industry sold $4.4 billion worth of goods making it one of the top five defense exporters in the world.[44] It would appear that Israel has learned how to replicate and reverse-engineer some

American military technologies. In fact, India and the United States are now the largest purchasers of Israeli military technology. High-technology industries, particularly military industries, will not be transferred from Israel to Egypt because of persistent regional tensions. Even if political conditions were favorable, Egypt lacks the human capital needed to fill a large number of positions in high-tech industries.[45] Overall, Israel can only rely on Egypt to supply low-skilled workers for labor-intensive industries. However, Egypt's competitive advantage through the QIZ will be eroded as developing countries in Asia and Latin America are granted PTAs with the United States.

Fourth, Egypt does not have a business climate that is highly conducive for increasing current levels of foreign direct investment.[46] High rates of corruption, restrictive labor laws, and extensive bureaucratic red tape make Egypt undesirable to most foreign investors. The end result is that Egypt is not well-integrated with the global economy. According to the WTO, Egypt's merchandise exports and imports combined currently constitute only 0.3 percent of total world trade, compared to 0.9 percent for the much smaller nation of Israel.[47] International trade is much more important to Israel than Egypt in both absolute and per capita terms.[48] Notably, Egypt has maintained a trade deficit almost continuously since WWII. Coupled with this dubious accomplishment is the fact that the trade deficit has been steadily growing. Thus, Egypt is not an export-oriented emerging market economy. Egypt would need to improve its infrastructure and regulatory environment dramatically to take advantage of the economic potential of the QIZ.

However, structural adjustment of the economy is unlikely, because the government lacks the legitimacy to impose even short-term austerity measures. The strong performance of the Muslim Brotherhood, particularly in poorer districts, in the last elections implies that austerity measures are unlikely, as the government seeks to avoid strengthening the ranks of the opposition. The government may increase public spending despite the large public debt in order to win support away from the Brotherhood. The government will pursue legislative changes to spur foreign investment, but it will simultaneously seek to avoid dislocating laborers from state-owned industries.

CONCLUSION

As it stands, the QIZ Agreement is neither a strategy for export-led growth nor an economic "road map to peace" in the region. It is primarily an initiative supported by textile manufacturing interests in Israel, Jordan, and Egypt. The provisions of the QIZ allow uncompetitive labor-intensive industries to remain afloat in spite of dramatic changes in the global economy. The QIZ does not promote much-needed reform and restructuring in Egypt's textile industry or the economy at large. Although the agreement does provide a fresh stimulus for exports and an injection of capital investment, it will not create enough jobs to revitalize Egypt's economy. The type of jobs that are created will be labor-intensive and low-skilled in areas that are not internationally competitive without a political agreement. The type of foreign direct investment will generally be confined to industries with sunset technology or relatively mobile factors of production (e.g., textile spinning and weaving machinery).

However, the future is not completely bleak. As the Israeli-Jordanian trade relationship declines with the implementation of the U.S.-Jordan PTA, a few more Israeli manufacturers may set their sights on Egypt. A surge in exports from Israel to Egypt in 2005 seemed to offset the decline in exports from Israel to Jordan (see Chart 3). This may be a temporary spurt, but it is yet another opportunity that the Egyptian government can exploit by improving the regulatory climate and creating incentives for greater diversification in the range and sophistication of industries qualified for participation in the QIZ. Of course, diversification should not be seen as a substitute for painful economic restructuring, but increased investment and export earnings may help to cushion some of the blow from the anticipated increase in unemployment and social unrest.

Although the agreement has broken the Arab taboo on conducting legitimate business with Israel, it will not automatically warm the cold peace between Egypt and Israel. The QIZ will only legitimate the ongoing economic ties among businessmen in a narrow range of industries. Since Egypt views the agreement as merely a stepping stone to a bilateral agreement with the United States, it is not heavily invested in promoting the social and political promise of the agreement. As Israel's effort to develop the social and political potential of the agreement was publicly rebuffed, it has little incentive to advance new initiatives. The United States would like to see warmer relations between Egypt and Israel, but it is distracted by several other pressing concerns in the region. Finally, as the agreement ignores the Palestinian economy, an underlying source of political tensions will not be massaged by the QIZ.

Nevertheless, Egypt stands to benefit economically if it pursues increased social ties with Israel. Robust social contacts, particularly among business elites, may enhance the capital-intensity of industries involved in the QIZ. Israelis are unlikely to relocate capital intensive industries to Egypt without warmer relations and trust between business partners. Of course, improved social contacts will alarm staunch conservatives in Egypt and throughout the Arab world. The Egyptian government could enhance business contacts, while still limiting general social interchange, by quietly expanding the role of the Egyptian-Israeli Chamber of Commerce or by working through the American Chamber of Commerce in Egypt. Egypt will need to reconsider improving relations with Israel, as the prospect for a bilateral Egypt-U.S. PTA has faded away.

In summary, all signatories to the agreement have achieved modest gains, but the full economic, political, and social potential of the agreement remains unexploited. Israel has increased exports and achieved public recognition for its business relations with an Arab state. America has nominally advanced the prospects for "free trade" in the region without paying a high cost in terms of imports. Egypt has managed to save a significant number of jobs in an important industry. However, the proliferation of bilateral PTAs in the Middle East will make the QIZ agreements obsolete within a decade, as international investors move their industrial platforms to gain unfettered access to U.S. markets. Thus, Egypt has earned a reprieve from the challenges of the global economy, but it seems paralyzed to undertake the necessary economic reforms to revitalize job growth or to advance bilateral relations with the United States. The Egyptian government will need to act quickly, quietly, and skillfully to achieve its remaining objectives in the coming years.

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APPENDIX A: Tables and Charts

Table 1: Preferential Trade Agreement Progress Chart (1985-2006)

	WTO[1]	GSP[1] Eligibility	TIFA[1]	BIT[1]	FTA
Israel	1995	n/e	--	--	1985; QIZ
Jordan	2000	X	X	2003	2001; QIZ
Bahrain	1995	n/e	2002	2001	2004
Morocco	1995	X	X	1991	2004
Oman	2000	X	2004		2006
UAE	1996	n/e	2004		Negotiations
Egypt	1995	X	1999	1992	QIZ
Tunisia	1995	X	2002	1993	
Kuwait	1995	n/e	2004		
Saudi Arabia	2005	n/e	2003		
Qatar	1996	n/e	2004		
Cyprus	1995	n/e			
Algeria	Observer*	X	2001		
Yemen	Observer*	X^	2004		
Lebanon	Observer*	X			
Iraq	Observer	X			
Libya	Observer	S.S. Terrorism			
Iran	Observer	S.S. Terrorism			
Syria		S.S. Terrorism			
Gaza/W Bank		X			QIZ

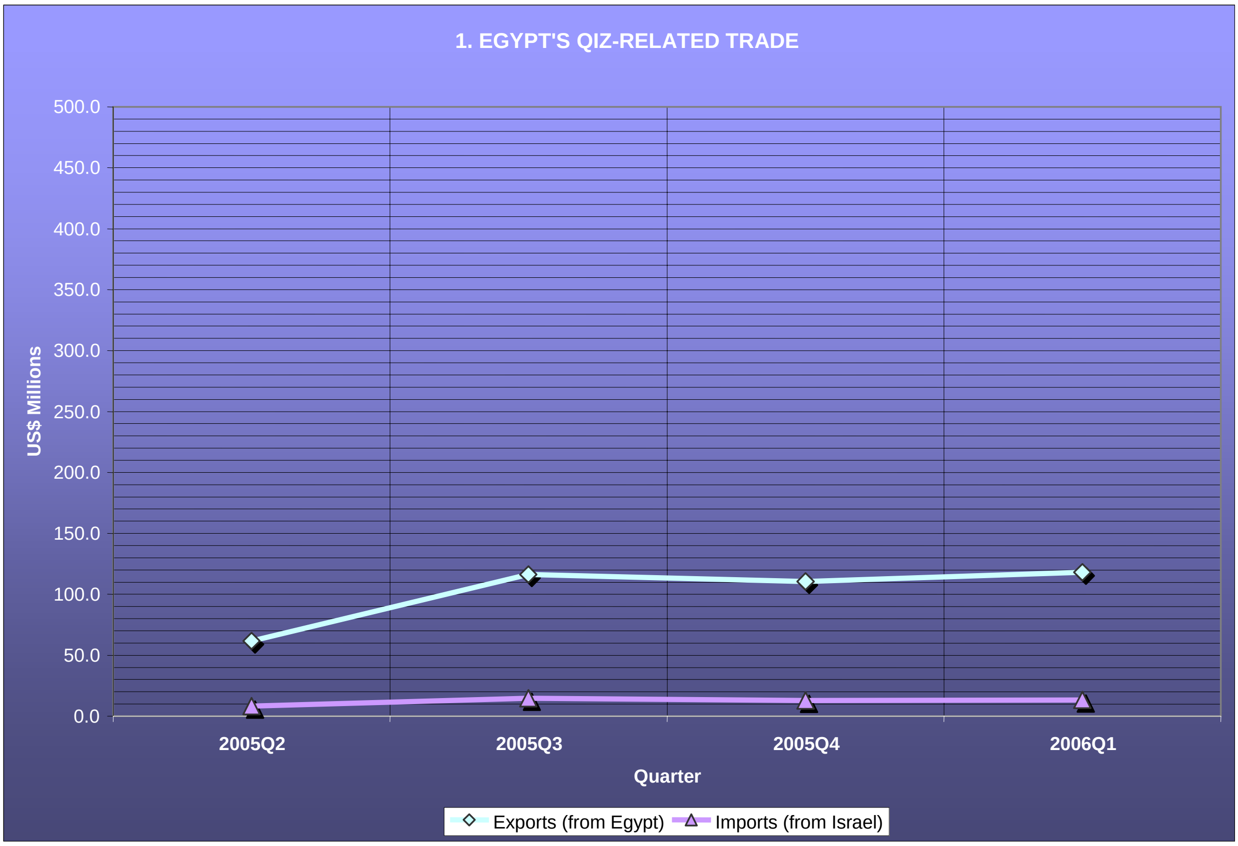
Legend: n/e = not eligible; -- = not relevant; * = U.S. support for full WTO membership; ^ = the Republic of Yemen is entitled to additional benefits as one of the least developed beneficiary developing countries (LDBDC); QIZ = Qualifying Industrial Zones Agreement; S.S. Terrorism = state sponsor of terrorism.

Table 2: Egyptian Firms Pre-qualified to Participate in QIZ

Size of Company	Number of Companies
<50	99
50-99	112
100-149	76
150-199	47
200-249	32
250-299	32
300+	231
N.A.	26
Total	655

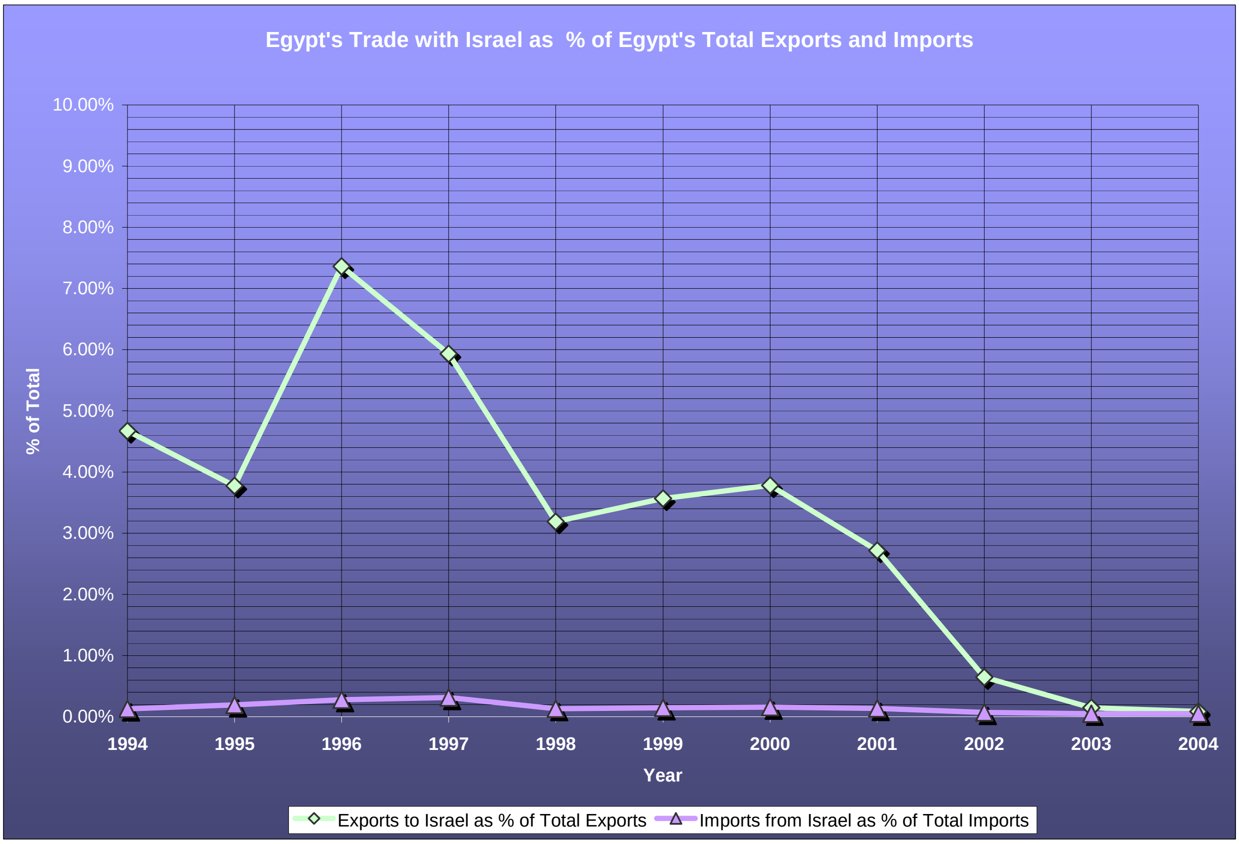
Source: QIZ Egypt, Ministry of Trade and Industry, Arab Republic of Egypt, "QIZ Company Statistics – 655 Companies approved until 14/02/2007," February 14, 2007, http://www.qizegypt.gov.eg/www/Downloads/Reports/Overall.pdf (accessed January 21, 2007).

Chart 1: Egypt's QIZ-Related Trade



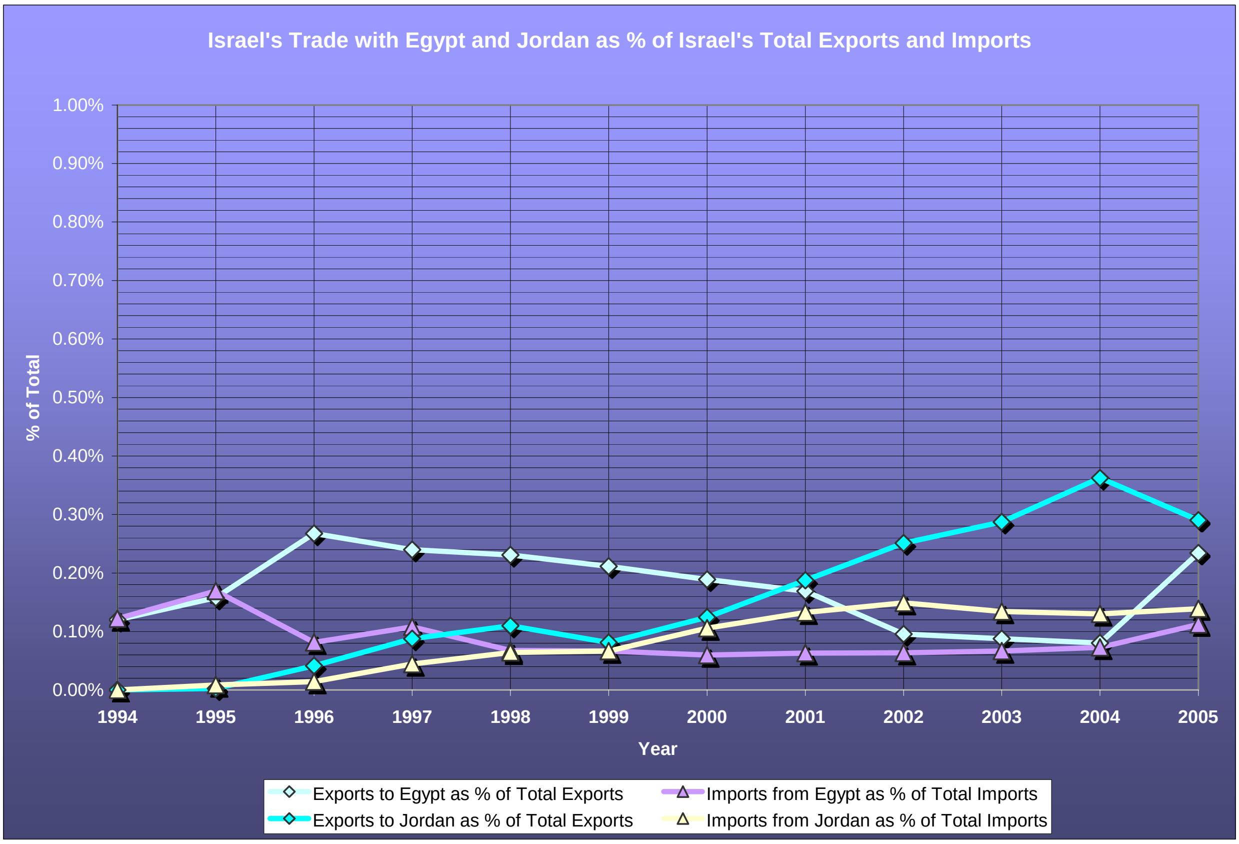
Source: Egyptian Ministry of Foreign Trade and Industry, QIZ Unit, http://www.qizegypt.gov.eg/english/QIZ%20-%20Statistics%20April%202006%20v2.ppt#415,1,QIZ%20Statistics.

Chart 2: Egypt's Trade with Israel as a Percentage of Egypt's Total Exports and Imports



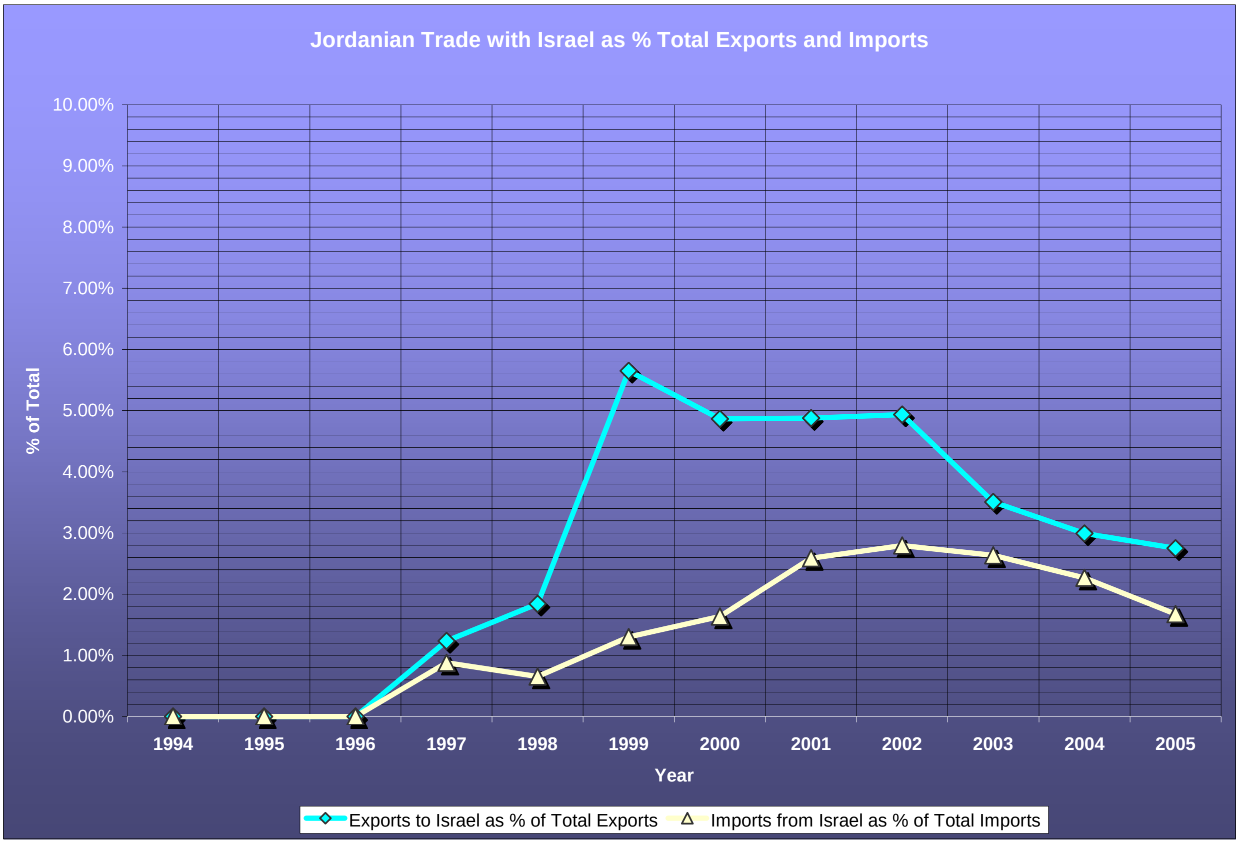
Sources: International Monetary Fund, International Financial Statistics, January 2007; United Nations Comtrade Database, January 2007.

Chart 3: Israel's Trade with Egypt and Jordan as a Percentage of Israel's Total Exports and Imports



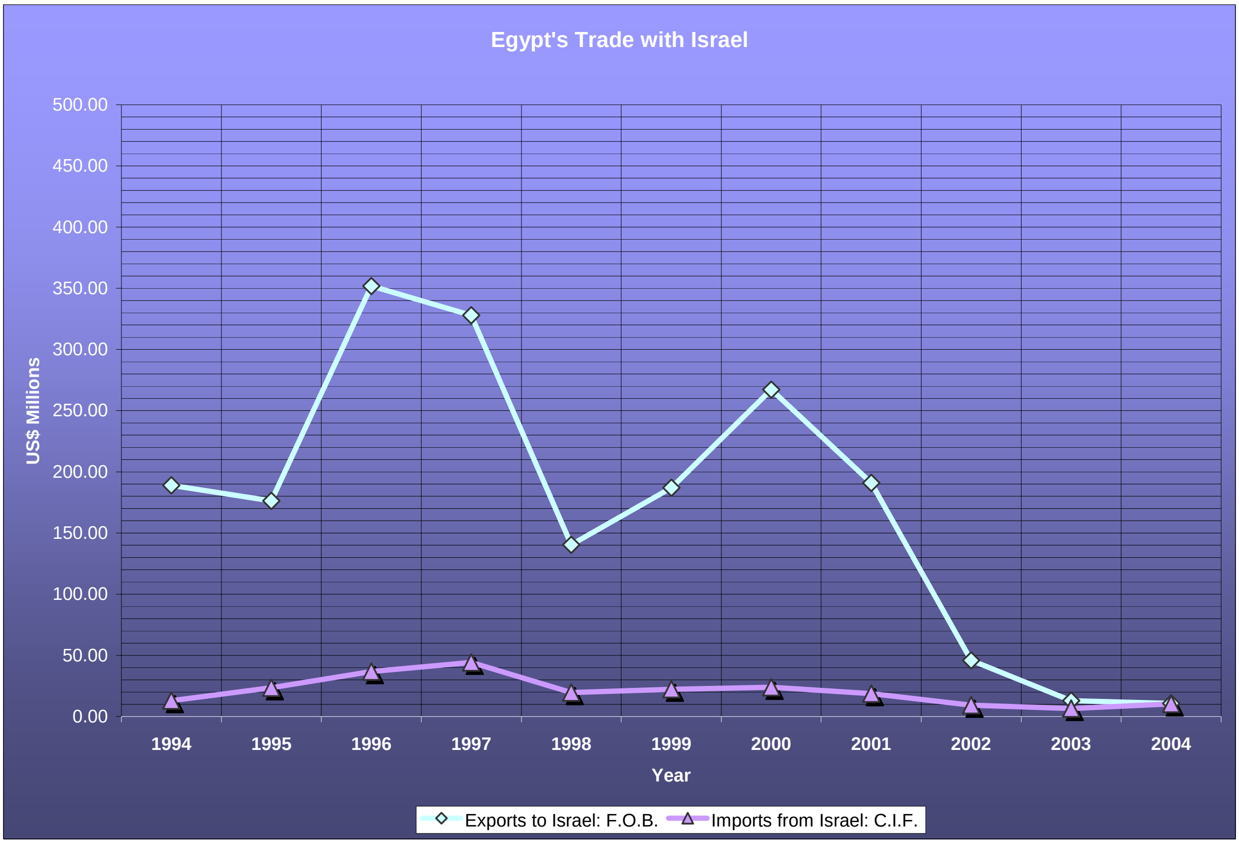
Sources: International Monetary Fund, International Financial Statistics, January 2007; United Nations Comtrade Database, January 2007.

Chart 4: Jordanian Trade with Israel as a Percentage of Total Exports and Imports



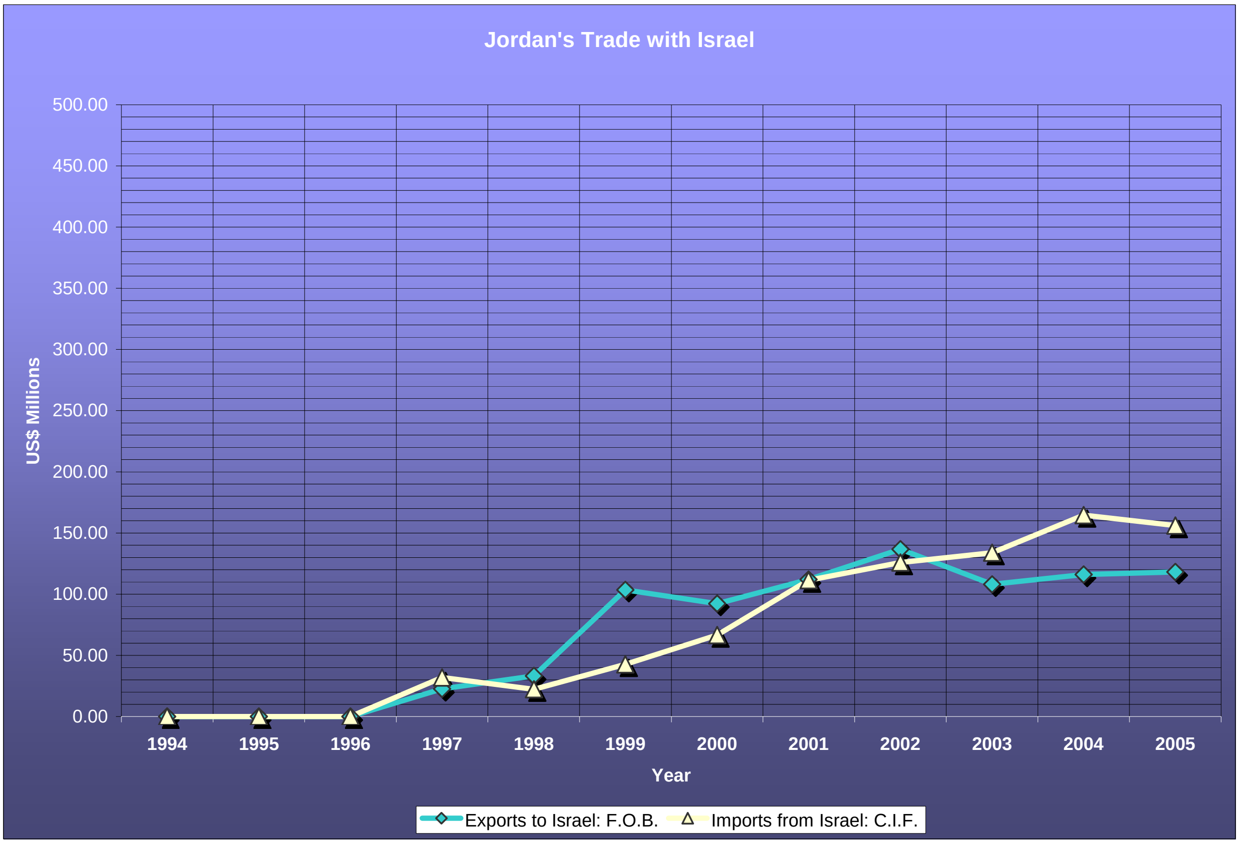
Sources: International Monetary Fund, International Financial Statistics, January 2007; United Nations Comtrade Database, January 2007.

Chart 5: Egypt's Trade with Israel



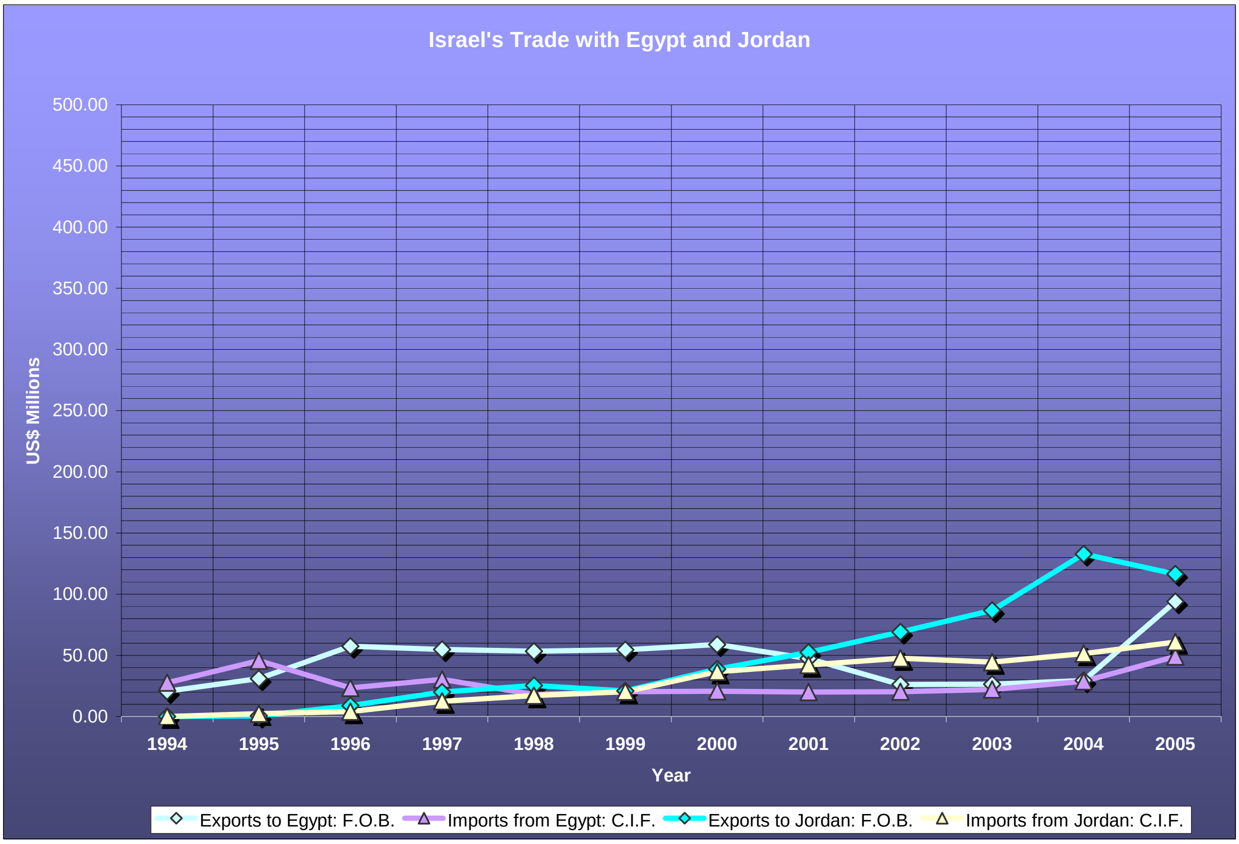
Source: United Nations Comtrade Database, January 2007.

Chart 6: Jordan's Trade with Israel



Source: United Nations Comtrade Database, January 2007.

Chart 7: Israel's Trade with Egypt and Jordan



Source: United Nations Comtrade Database, January 2007.

NOTES

[1] In fact, the document signed by Egypt, Israel, and the United States at the ceremony was not the QIZ Agreement, but rather a letter informing the U.S. Congress that Egypt and Israel had reached an agreement on establishing qualifying industrial zones. Confidential interview by the author, June 2, 2005.

[2] "Country Report: Egypt." *Economist Intelligence Unit*, February 18, 2005.

[3] The QIZ Agreement contradicts the prevailing theory on the proliferation of preferential trade agreements (PTAs), which asserts that "the prospect of closure [of the international trading system] heightens the risks faced by states that depend on international trade and raises the value of striking agreements that guarantee preferential access to foreign markets. Thus, the factors that threaten to undermine the global trading system are likely to stimulate the formation of PTAs." Edward D. Mansfield, "The Proliferation of Preferential Trade Agreements," *Journal of Conflict Resolution*, Vol. 42, No. 5 (October 1998), p. 525.

[4] "Country Report: Egypt."

[5] Egyptian elites are generally unaware of the fact that relations with Israel have been "normalized" since 1978. Many Egyptians either do not realize or refuse to acknowledge that extensive diplomatic, cultural, business, and travel links exist between the former adversaries. Nevertheless, there is an Israeli embassy, Israeli Academic Center, Egyptian-Israeli Chamber of Commerce (in Tel Aviv), and bus and air links between the two countries.
[6] Confidential interview with the author, February 27, 2006.
[7] Confidential correspondence with the author, February 24, 2006.
[8] The initial agreement created seven qualified zones (Shobra al-Khayma, 10th Ramadan City, 15th May Industrial Zone, Badrashayn, Borg al-Arab, Amareya and Port Said). The seven zones were chosen because of their potential to produce high-value textile products for the export market. "Country Report: Egypt." Currently, there are four main zones with multiple sites in each zone (1. Greater Cairo: Giza, Shubra al-Khayma, Nasr City, 10th Ramadan City, 15th May City, Badr City, 6th October City, Obour City, Kalyoub City, and the industrial area in Gesr al-Suez; 2. Alexandria; 3. Suez Canal Area: Port Said, Ismailiyya, Suez; 4. Middle Delta: Gharbia, Dakahlya, Monofia, Dommiata). Source: http://www.qizegypt.gov.eg/www/english/About/about_qiz_locations.asp (accessed January 16, 2007).
[9] Jewish Virtual Library, "Israel-Egypt: A Review of Bi-lateral Ties," American-Israeli Cooperative Enterprise, January 2003, http://www.jewishvirtuallibrary.org/jsource/Peace/egyptisrael.html (accessed August 15, 2006).
[10] In fact, Egypt claimed to export $351.8 million worth of goods (or 7.36 percent of Egypt's total exports) to Israel in 1996 (see Charts 2 and 5).
[11] In fact, by the third quarter of 2006, according to the Israeli Export and International Cooperation Institute (IEICI), total Israeli exports to Egypt increased by 32 percent, to $92 million, over the same period in the previous year. *Ynet News*, December 3, 2006, http://www.ynetnews.com/articles/0,7340,L-3335306,00.html (accessed January 16, 2007). See also: *Jerusalem Post*, February 10, 2006.
[12] United States Trade Representative, *2005 Trade Policy Agenda and 2004 Annual Report of the President of the United States on the Trade Agreements Program* (Washington, D.C.: GPO, 2004), p. 7.
[13] *Ibid*, p. 187.
[14] Confidential interview by the author, June 2, 2005.
[15] *The United States-Israel Free Trade Area Implementation Act of 1985*, 19 U.S.C. 2112. Note that preferential trade agreements are often called free trade agreements. This paper will attempt to use the proper terminology for each type of agreement.
[16] The act was considered and passed in the House on April 16, 1996 and considered and passed in the Senate on September 27, 1996. HR3074, 104th Cong., 2nd session (April 16, 1996), *Cong. Rec.*, 142; *West Bank and Gaza Strip Benefits*, Public Law 104-234, *Cong. Rec.* 142: 3057-3058.
[17] The U.S.-Israel agreement was only the second PTA signed by the United States at the time. The first was the Caribbean Basin Initiative signed shortly before the agreement with Israel.
[18] Anne O. Krueger, "Are Preferential Trade Agreements Trade-Liberalizing or Protectionist?," *Journal of Economic Perspectives*, Vol. 13, No. 4 (1999), p. 107.

[19] Charlene Barshefsky, "Designation of Irbid Qualifying Industrial Zone," Press release by the U.S. Embassy in Amman, Jordan, March 6, 1998, http://www.usembassy-amman.org.jo/wwwhqiz5.html.
[20] *Middle East Economic Digest*, May 29, 1998.
[21] *Asia Africa Intelligence Wire*, October 9, 2005.
[22] *Middle East Economic Digest*, May 29, 1998.
[23] *Asia Africa Intelligence Wire*, February 8, 2006; "Country Report: Egypt."
[24] "Country Report: Egypt."
[25] United States Trade Representative, *2005 Trade Policy Agenda*, p. 187.
[26] *Globes*, March 8, 2006.
[27] *Ynet News*, December 3, 2006, http://www.ynetnews.com/articles/0,7340,L-3335306,00.html (accessed January 16, 2007).
[28] *Financial Times*, October 27, 2006.
[29] Confidential interview by the author, February 27, 2006.
[30] *Financial Times*, October 22, 2003.
[31] *Financial Times*, September 29, 2005.
[32] Confidential interview with author, February 27, 2006.
[33] *Jerusalem Post*, June 1, 2005.
[34] It should be noted that although new jobs are being created in Egypt, Israel has lost 60 percent of its 29,000 textile jobs in the last ten years. In 2005, 12 sewing workshops were closed and 1,500 workers were laid off in Israel. *Globes*, March 8, 2006.
[35] *Women's Wear Daily*, December 12, 2006.
[36] QIZ Egypt, Ministry of Trade and Industry, Arab Republic of Egypt, "QIZ Statistics," http://www.qizegypt.gov.eg/www/Downloads/Presentations/15-08-2006_QIZPresentation.pdf, (accessed January 21, 2007).
[37] QIZ Egypt, Ministry of Trade and Industry, Arab Republic of Egypt, "Frequently Asked Questions," http://www.qizegypt.gov.eg/www/english/About/about_qiz_faq.asp, (accessed January 21, 2007).
[38] American Chamber of Commerce in Egypt "Egypt and the US: Investing in Partnership," March 2006, http://www.amcham.org.eg/BSAC/ustrade/pdffiles/QIZBrochure06.pdf, (accessed January 21, 2007).
[39] Emerging Textiles.com, November 21, 2006, http://www.emergingtextiles.com/?q=art&s=061121Egypt&r=free&n=1 (accessed January 21, 2006); See also U.S. Embassy in Cairo, "Remarks by the Chargé d'Affairs Stuart Jones before the Egyptian Businessman's Association [As Prepared for Delivery]," September 13, 2006, http://cairo.usembassy.gov/pa/tr091306.htm (accessed January 21, 2007).
[40] *Ibid*.
[41] *Ha'aretz*, December 19, 2004.
[42] "Egypt: Country Commerce," *Economist Intelligence Unit*, July 22, 2005.
[43] Nicholas R. Lardy, *Integrating China into the Global Economy* (Washington, D.C.: Brookings Institutions Press, 2002), p. 23.
[44] *Jerusalem Post*, January 2, 2007.
[45] For example, an examination of industrial patents shows that of the 325 patents granted to Egypt, residents earned only 64 of them. All 2,249 trademarks registered in 2004 were to non-residents. Israeli residents earned 311 of that country's 1,814 industrial patents in 2003, and 168 trademarks out of 4,600 in 2004. World Trade Organization, "International Trade Statistics Database," http://stat.wto.org/, September 2006.

[46] Egypt had only 99 affiliates of foreign corporations in 1999 (the last year for which data is available), while Israel had 131 affiliates in 2003. UNCTAD, *World Investment Report: The Shift Toward Services* (New York, NY: United Nations, 2004), p. 273, Annex Table A.I.2.

[47] Egypt ranks a mediocre 68th globally in terms of merchandise exports and 58th for merchandise imports, while Israel ranks 42nd for exports and 41st for imports of merchandise goods. Egypt and Israel are comparable in terms of trade in services. Egypt ranked 33rd for exports in commercial services and 42nd for imports in 2004. Israel placed 30th for exports and 35th for imports of commercial services. World Trade Organization, "International Trade Statistics Database."

[48] Exports plus imports constituted nearly 87 percent of GDP in Israel from 2003-2005, but only 62 percent of Egypt's GDP in the same period. More importantly, trade constituted 83 percent of per capita income for Israelis while trade made up 59 percent of per capita income for Egyptians. World Trade Organization, "International Trade Statistics Database."