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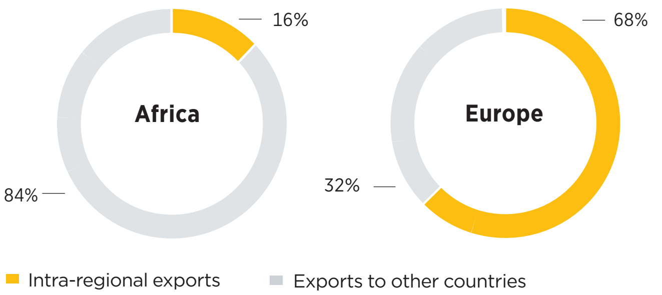
The African Continental Free Trade Agreement (AfCTA): a potential engine for regional integration

Flowers being exported from Kenya to the Netherlands, just to be shipped all the way back to the African continent to be imported into Nigeria. This is just one illustrative example of a far larger issue affecting the entire continent, namely, the lack of established intra-regional trade routes within Africa.

Intra-African trade needs an upgrade

Intra-regional trade is underdeveloped in Africa compared with other parts of the world (as illustrated by the yellow sections in Chart 1). The majority of African trade is conducted with other continents, such as Europe and Asia. One main reason is Africa's abundance of primary commodities (such as minerals and agricultural products) which attract continued interest from advanced economies and thus dominate Africa's exports to other continents.

Chart 1: **Share of intra-regional exports, 2019**



Source: United Nations Conference on Trade and Development (UNCTAD)

However, real **barriers have also stood in the way of intra-African trade**. Tariffs have played a role, but non-tariff barriers – which, according to an IMF study, include infrastructure, credit access for the private sector, the business environment and trade logistics (e.g. customs and trade regulations)[1] – have been more detrimental.

The idea of reducing tariffs and fostering regional economic cooperation is not new in Africa. Indeed, at present, there is a network of 17 regional economic blocs across Africa. Nevertheless, the IMF believes that the existing arrangements are underperforming, mainly due to a low level of implementation, a lack of institutional backing and multiple memberships.[2] The Southern African Development Community (SADC) and the East African Community (EAC) have proved the most successful at fostering regional integration, with export volumes among members accounting for 20% and 17% of total intra-African trade volumes, respectively. In contrast, exports between member countries are least developed in the Central African Economic and Monetary Community (CEMAC), which accounts for just 2% of the total. Due to the low levels of intra-African trade, related **customs revenues are generally also suppressed**, ranging from 2.5% of GDP in Djibouti (a small port-driven economy), to less than 0.1% of GDP in Nigeria (Africa's largest economy).

At a time when infrastructure investments in Africa are gathering momentum (to a large extent as a result of the Chinese Belt and Road Initiative), working towards overcoming barriers to intra-regional trade and establishing a pan-African regulatory trade framework is a logical and important priority.

[1] IMF: Regional Economic Outlook: Sub-Saharan Africa— Recovery Amid Elevated Uncertainty, Washington, 2019
[2] IMF: The African Continental Free Trade Area: Potential Economic Impact and Challenges, Washington, 2020

Liberalised trade in goods as a first step

After several years of negotiation, 54 out of the 55 countries within the African Union (Eritrea being the exception) have signed the long-awaited treaty to establish the African Continental Free Trade Area (AfCFTA). Meanwhile, more than 35 countries have ratified the agreement and trade regulations have started to be gradually implemented from January 2021. **The agreement covers only intra-African trade in goods "made in Africa"**, i.e. most of the current export/import transactions are unaffected, as they are conducted with countries outside the continent.

It has been agreed **that in trade of goods, 90% of tariff lines will be gradually reduced to zero** over a period of five years (+five years for less-developed countries).[3] Tariffs on 7% of "sensitive goods" will be eliminated within 10 years (+three years for less-developed countries), whereas tariffs on 3% of "excluded products" remain in place. Each country decides individually which products need to be protected as "sensitive" or "excluded" goods, and this process is expected to be finalised by mid-2021. Around the same time, it is expected that rules of origin will have been negotiated; something that is essential for the smooth running of AfCFTA given these rules define the criteria that determine whether a product can be labelled as "made in Africa".

Regarding trade in services, regulations will be liberalised, starting with five priority sectors (business services, financial services, transport, communication and tourism). This is a complex process involving harmonising regulatory standards across countries, and details are currently still being negotiated.

After five years, member countries have the option to declare their withdrawal from the agreement. This would become effective after a transitional period of two further years.

In order to facilitate the agreement, an institutional framework has been established comprising a committee for trade in goods, another for trade in services, and a dispute settlement body. Online apps have also been announced, *inter alia*, to report perceived violations of the treaty. **A permanent secretariat** is hosted by Ghana and will support these committees, while decision-making powers lie with the sovereign states, which convene in ministerial councils or the AfCFTA assembly.

For the time being, the **existing regional economic blocs in Africa will remain in place**. In these cases, AfCFTA regulations act as the minimum standard and will, in practice, primarily apply to trade with African countries outside the respective blocs.

Implementation of the free trade agreement lies in the hands of the individual signatory countries. Therefore, it is likely that sizeable administrative hurdles will remain for exporters and importers, especially in terms of the paperwork required to obtain preferential treatment under AfCFTA.

The next steps towards deeper intra-regional trade integration

Signing and ratifying the AfCFTA was just the first step towards overcoming the various obstacles to regional integration in the coming months and years. The key to unlocking the transformative potential of the trade agreement is implementing the terms effectively at the country level, as well as orchestrating the required policy reforms; all of which may take some time.

The major challenge in the context of the agreement is the **ubiquity and high cost of Africa's non-tariff barriers.** These hinder trade within the continent and need to be substantially reduced. To tackle this burden effectively, the full spectrum of barriers should be addressed, including seeking to improve the business environment and plug the infrastructure gaps. Progress on these matters will be key for the success of the AfCFTA, as non-tariff barriers are a critical obstacle for intra-regional trade and are estimated to have an even bigger impact than tariff liberalisation.
Many outstanding issues have already been identified and incorporated into the agenda for upcoming discussions, as shown in Chart 2. Phase 1 is already progressing, and **the protocols for Phase 2 comprise intellectual property rights, investment and competition policy**, for which negotiations are scheduled to start in 2021. These additional protocols will, in effect, lay the foundations for a single market on the continent.

Chart 2: **Stepwise negotiation of AfCFTA**

Source: Adapted from UNDP

[3] A group of 6 countries (Ethiopia, Madagascar, Malawi, Sudan, Zambia, Zimbabwe) has secured an even longer transitional period of 15 years for tariff liberalisation

A major constraint for economic growth and development could be **weak enforcement of rules of origin**. As the AfCFTA does not preclude a member state from entering into a trade agreement with third countries, the potential for trade deflection remains an issue that could undermine the process of industrialisation across the continent. Third parties could re-route their exports to the member nation with the lowest external trade barriers and gain access to the broader intra-regional market.

The African economic miracle?

The launch of the trade agreement's operational phase has shifted focus towards achieving an integrated, industrialised and prosperous continent.

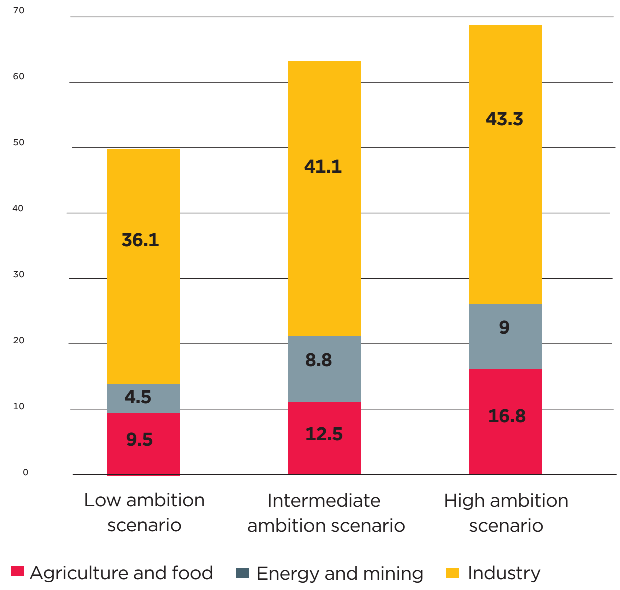
When looking at research and analysis on the expected impacts, there are several reports by international agencies, such as the IMF and the World Bank. Findings suggest that **intra-regional trade in Africa will grow, but starting from a relatively low basis**, as already mentioned.

At present, intra-African goods exports amount to USD74 billion (2019). The United Nations Economic Commission for Africa (UNECA) predicts these exports to increase to approximately USD300 billion in 2040 in a non-AfCFTA scenario. **Under the new agreement, exports are estimated to benefit from additional volumes ranging between USD50 and 70 billion (see Chart 3).[4] Industrial goods are expected to yield the most benefit**, including machinery, vehicle equipment, electronics and pharmaceuticals. Today, this sector accounts for 47% of intra-African exports. The share could increase to 60% in the most optimistic scenario of additional exports in 2040 (see Chart 3). This indicates **that expanding regional trade and accelerating the process of industrialisation are highly correlated**. The development is likely to further facilitate the **creation of national and regional value chains**, as is currently already happening in Ghana, for example, with the cocoa trade: rather than just exporting the raw materials, there has been a shift towards value-enhanced processing and increased chocolate production.

The banking sector plays an important role in facilitating investment and trade within the continent. Several major African banks have already expanded from countries like South Africa, Morocco, Nigeria and, more recently, Egypt, to become pan-regional players across the continent. At Commerzbank, we aim to partner with such banks as it enables us to efficiently cover the continent, and find solutions for our corporate customers by bridging continents and regions.

Overall, the AfCFTA impact on government income will be only marginal in the short term. But in the medium term, tariff revenue losses will likely be compensated for by upcoming welfare gains due to higher trade volumes and

Chart 3: **Expected additional intra-African goods exports in 2040* in USD bn**



*compared to non-AfCFTA scenario of USD300 bn

Source: Adapted from the United Nations Development Programme (UNDP)

economic growth. **Income and distribution at the country level will vary significantly**, depending on the openness of each nation. According to a study by the World Bank, the highest gains are expected in countries that currently have high trade costs, such as Côte D'Ivoire, which should see an increasing income of 14% by 2035.[5]

Realising the potential, and driving recovery from the COVID-19 pandemic, both hinge on the remaining negotiations under the agreement. But to reap the full benefit, infrastructure investments are key, and these may also act as a booster in the medium term. **Coordinated action to connect fragmented markets can translate into comparative and competitive advantages.** For instance, countries can focus on producing certain goods and services, and their resources will be shifted to the most efficient sectors, which should produce economies of scale. **The expected productivity gains can, in turn, increase the returns on infrastructure investments**. To pursue this dynamic and business-oriented approach, the concept of "Industrial Parks and Special Economic Zones" will become increasingly important.
They could serve as magnets for investors by shifting foreign direct investment (FDI) from primary commodities and natural resources, towards manufacturing and industrial production. However, this will be a lengthy process and will depend on the willingness for regional cooperation and a unified understanding of those needs; something that, in the past, has not always been unanimous.

[4] UNDP: Making the AfCFTA work for women and youth, New York, 2020
[5] The Worldbank Group: The African Continental Free Trade Area – Economic and Distributional Effects, Washington, 2020

Opportunities and effects from a non-African perspective

Since the AfCFTA is expected to touch all economic sectors of the African continent, this raises the question of the extent to which other areas of the world may also be affected by the agreement, and whether there may be ways to participate from outside the continent.

One possibility for immediate participation is, of course, FDI. Increased capital inflows are expected due to higher economic growth and progress on the continent. In previous years, inflows were mainly directed towards countries such as Ghana, Egypt and Ethiopia. But the elimination of tariffs should provide further encouragement for investors to also invest in other countries, tapping into the African market via production facilities and distribution possibilities within the continent.

When looking at trade, there are only limited immediate opportunities for non-African corporates in the short term. For goods that do not contain African products, we do not see any immediate benefits. Yet, for those goods containing African products, there may be the opportunity to label them "made in Africa", and thereby entitled to the associated advantages – depending on how the rules of origin are negotiated, defined and enforced.

Opportunities for trade of non-African products should arise in the medium and long term, as a result of the improved business environment. In addition, there will also likely be opportunities to benefit from **investment in infrastructure** and related export contracts for the expansion of ports, road networks and railways.

Alongside the positive effects, there are also challenges. The shortage of foreign currency reserves could further intensify, driven by the costly infrastructure investments and expected commodity price reductions in the coming years. In the long term, there is the possibility that **intra-African trade could replace imports from outside Africa**, such as Europe. In addition, it is likely that **Africa's negotiating power in international trade** negotiations could strengthen at the expense of advanced economies, as Africa's importance in global value chains increases.

Conclusion

AfCFTA is a crucial initiative that could have a transformative impact on African economies. The first successful step was liberalising the trade in goods that are "made in Africa", but it remains to be seen if the agreement will make further progress towards intra-regional integration on the continent, and a single market among the African Union members.

To maximise the potential benefits of the agreement, **further negotiation and decisive action, as well as collective efforts on the part of African states, are necessary.**

For the time being, there are only limited immediate opportunities for non-African corporates participating in trade. These include **foreign direct investment** into promising sectors, acting as a supplier for infrastructure projects, or simply satisfying the general consumer demand of the fast-growing African population.

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