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PEGNet Policy Brief

Potential Economic Benefits of the African Continental Free Trade Area for Africa and the EU

Julian Hinz, Sonali Chowdhry, Anna Jacobs, and Rainer Thiele

KEY POINTS

- Despite some growth, intra-African trade activity remains at low levels and falls far behind the levels of internal trade observed in more integrated regions like the EU.
- The European continent remains a major trading partner, but its share in total African exports and imports has decreased from nearly 50% to 35% between 2000 and 2020.
- Our simulations suggest that implementing the African Continental Free Trade Area (AfCFTA) agreement can lead to substantial welfare gains in Africa, but only if tariff reductions are accompanied by a significant lowering of Non-Tariff-Barriers (NTBs).
- If NTBs are reduced on a multilateral basis, the EU's declining trade share with Africa might also be reversed.
- European governments and EU institutions should therefore have an incentive to provide technical and financial assistance – possibly within the framework of the existing WTO-led aid-for-trade initiative – to help AfCFTA economies lowering NTBs on a multilateral basis.

In May 2019, the African Continental Free Trade Area (AfCFTA) agreement entered into force. In numerous respects, the AfCFTA can be considered a historic milestone towards trade liberalization on the African continent. Following ten rounds of official negotiations beginning in June 2015, the agreement now spans 54 African Union Member States, of which 43 have already deposited their instruments of ratification.[1] By connecting these economies, the AfCFTA has become the largest trading bloc in the world in terms of market size, covering more than 1.3 billion consumers with a combined GDP of USD 2.5 trillion. Its core objective is to deepen the economic integration of the African continent by creating a single market for the movement of goods, services, capital and natural persons. As a result of deeper integration, the AfCFTA is expected to support African economies achieve rapid industrial development, diversify their export baskets and make progress towards the UN Sustainable Development Goals (SDGs). In this policy brief, we assess the status quo of trade within AfCFTA economies and between AfCFTA and EU economies, and outline three hypothetical future outcomes of the AfCFTA for different levels of trade liberalization.[2] These scenarios point to the potential welfare gains of the AfCFTA, while we do not address the issue of how likely it is that policy makers actually implement the welfare-enhancing policies. [3]

Status quo of African trade relations

Figure 1 shows the status quo of intra-African trade integration. Despite some growth, intra-African trade activity remains at low levels and falls far behind the levels of internal trade observed in more integrated regions like the EU. In fact, the share of internal trade on the European continent is almost seven times as high as on the African continent, and still only a quarter of intra-American trade. Furthermore, no clear upward trend is visible within Africa.

For AfCFTA member states, the European continent remains a major trading partner (Figure 2). However, the EU's share in total African exports and imports has decreased steadily over the years. Between 2000 and 2020, it has dropped from nearly 50% to 35%. African exports to Asia – most notably China – on the other hand increased by almost 20 percentage points over the period considered, reaching a share of around 30% in 2020. Looking at African imports, this substitution effect is equally apparent. In 2013, Asia replaced the EU as the main import partner for the African continent. Its overall share in African imports rose by more than 15 percentage points within the past 20 years. The agreement's successful implementation is therefore a strategic priority in the EU's evolving relationship with Africa and offers an opportunity to arrest the gradual decline in its relative importance as a trading partner for African economies.

In terms of traded products, African exports are dominated by commodities and raw materials. This industrial structure is markedly different from that of the EU and therefore reduces the likelihood of intra-African integration diverting trade away from the EU.

1 Information as of May 2022
2 The policy brief is based on a recent study (Hinz et al. 2022) commissioned by Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ).
3 For a detailed account of the various factors that might prevent the AfCFTA from reaching its potential, see for example Asche (2021).

PEGNet
Poverty Reduction, Equity and Growth Network

KIEL INSTITUTE FOR THE WORLD ECONOMY
Kiellinie 66 | 24105 Kiel

E pegnet@ifw-kiel.de
www.pegnet.ifw-kiel.de

@PEGNetKiel

Figure 1 Share of internal imports and exports by continent

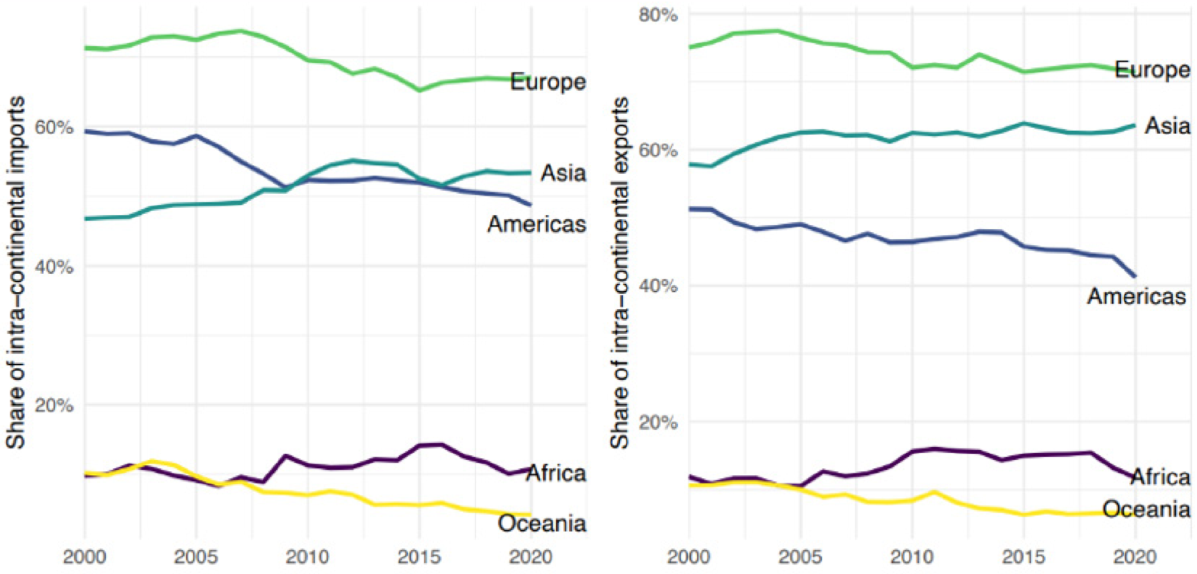
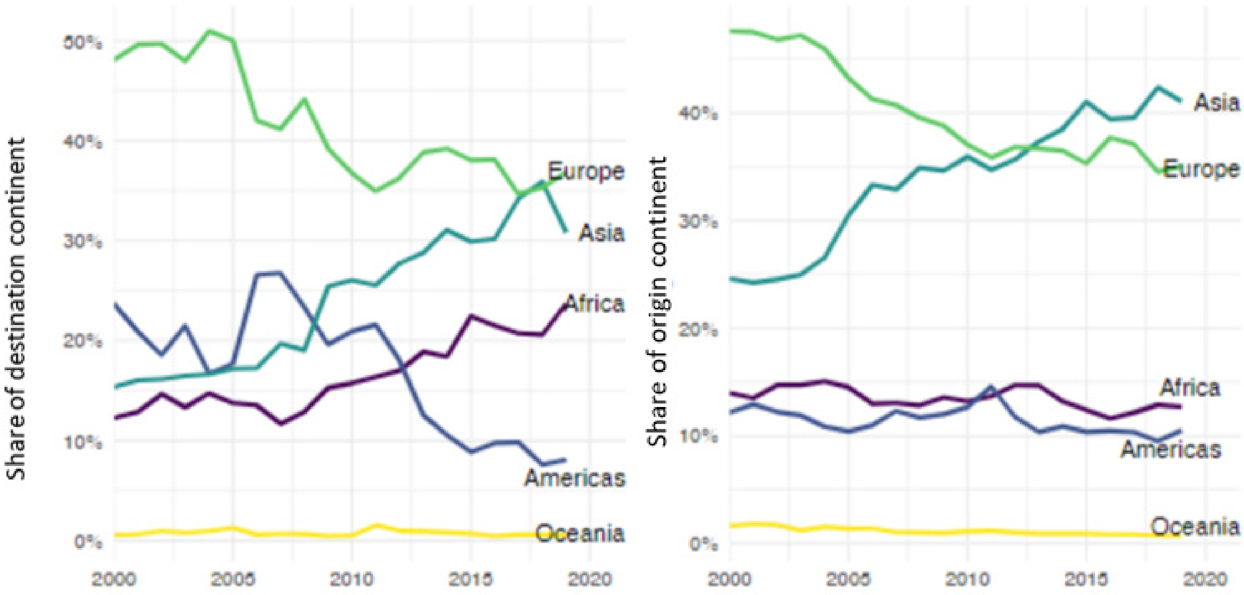


Figure 2 African export destinations and import origins over time



For the EU itself, the African continent is — in overall economic terms — a relatively minor trading partner. Its share of exports to African economies in total exports persistently stays around 2%. For both African exports and imports, trade with the EU is concentrated among a few countries in the geographic North of the continent, i.e. Morocco, Tunisia, Algeria, Libya and Egypt, with one exception, South Africa. Within the EU, Germany is the second-largest exporter to and the third-largest importer from AfCFTA members. Importantly, its trade relationship with African economies is unique in several ways: Compared to overall imports from the EU, African economies source industrial goods such as machinery, electrical appliances, vehicles and transport equipment much more intensively from Germany. This pattern is also observable in AfCFTA exports to Germany, even though this is mainly driven by South African-German trade, especially in motor vehicle-related goods.

Three Scenarios for AfCFTA Implementation

The AfCFTA is designed to be a comprehensive and deep trade agreement. Focusing on the AfCFTA's Protocol for Goods, the agreement mandates the progressive removal of tariffs on at least 97% of tariff lines. 90% of tariff lines are expected to be completely eliminated over a period of 10 years for Least Developed Countries (LDCs), over 5 years for non-LDCs and over 15 years for a separate group of six nations (Ethiopia, Madagascar, Malawi, Sudan, Zambia, Zimbabwe). Gradual tariff elimination on the additional 7% of tariff lines for relatively sensitive products will begin only after five years. The long transition periods for LDCs underline the importance of tariff revenues for government budgets in African states, which cannot immediately be substituted by domestic taxes. As concerns Non-Tariff Barriers (NTBs), the AfCFTA's Protocol for Goods incorporates several Annexes dedicated to trade facilitation, Technical Barriers to Trade (TBTs), Sanitary and Phyto-Sanitary measures (SPS), trade remedies and transit facilitation. On trade facilitation, for example, AfCFTA members commit to establishing electronic payments, maintaining a single window system for document submission, and arranging for pre-arrival processing of goods amongst others.

To quantify and evaluate the effects of the entry into force of the AfCFTA for its members, Germany and other EU countries, we compare a baseline simulation scenario (i.e. a world without the AfCFTA) to three stylized counterfactual states of the world economy in which the level of trade liberalization under the AfCFTA varies:[4]

Scenario 1: All intra-AfCFTA tariffs are eliminated whereas the external tariffs, i.e. tariffs for non-AfCFTA economies, remain as in the status quo, which means that the AfCFTA does not alter the Most Favored Nation (MFN) or preferential tariffs imposed by the bloc's members on imports from non-AfCFTA economies.

Scenario 2: Intra-AfCFTA NTBs are lowered by 10% in addition to eliminating all intra-AfCFTA tariffs. External tariffs and NTBs faced by third-party exporters to the AfCFTA remain unchanged. The elimination of import quotas under the AfCFTA can be considered a fitting example of such bilateral reductions in NTBs. While the AfCFTA mandates the removal of quantitative import restrictions within the bloc, they continue to apply to third party exporters.

Scenario 3: In addition to the liberalizations from Scenarios 1 and 2, NTB reductions by 10% are extended to all trading partners, e.g. through provisions that improve customs procedures and thereby red tape barriers faced by all firms trading with AfCFTA economies irrespective of their origin. Extra-AfCFTA tariffs remain in place.

Table 1 summarizes the simulated economic outcomes of the different AfCFTA implementation scenarios. Looking at Scenario 1, we observe that tariff elimination alone provides only a marginal boost to AfCFTA's global exports (0.37%), an increase which is directed only towards other AfCFTA economies. Meanwhile, tariff revenues earned by member states drop by nearly 7%. This significant reduction in tariff revenues offsets any increase in income (defined here as nominal GDP) that AfCFTA members potentially experience from growth in their exports. Overall, the impact of the agreement on AfCFTA economies under this counterfactual is low. This is apparent even when looking at the change in AfCFTA members' production or real GDP (0.3%).

Table 1 Economic impact of the three different scenarios for AfCFTA member countries

	Scenario 1 Tariffs only	Scenario 2 Tariffs + bilateral NTBs	Scenario 3 Tariffs + multilateral NBTs
Change in Global Exports	0.37%	17.1%	21.9%
Change in intra-African Exports	0.37%	22.7%	19.2%
Change in Exports to EU	≈ 0%	-18.2%	29.5%
Change in Tariff Revenue	-6.92%	8.5%	17.2%
Change in Income	≈ 0%	10.9%	18.1%
Change in Production (real)	0.3%	23.9%	29.2%

4 The simulation exercises are carried out with the KITE model ("Kiel Institute Trade Policy Evaluation Model"). This model pays particular attention to intra- and international input-output linkages that reflect the cross-border nature of production today. Therefore, the model captures key aspects of the modern world economy, where countries are highly interconnected through Global Value Chains (GVCs). Moreover, in the context of our application, GVCs imply that countires that are not members of AfCFTA may still be affected by the agreement. For technical description of the model, see appendix B of Hinz et al. (2022).

The results of Scenario 2 and Scenario 3 show that the main boost to trade comes from a reduction in NTBs. If intra-AfCFTA's NTBs are reduced by 10% (Scenario 2), members would experience global export growth by up to 17% alongside an even steeper growth in intra-AfCFTA exports (22%), which reflects markedly deeper regional trade integration. The scenario highlights that NTBs, rather than tariffs, constitute the critical barrier to AfCFTA trade both amongst its members as well as the ROW. The model simulations also show an increase in tariff revenues for AfCFTA economies, in contrast to Scenario 1. This is driven by AfCFTA economies increasing their imports from the ROW, imports on which they continue to charge tariffs. The combination of high export growth and a jump in tariff revenues then contribute towards an increase in AfCFTA income by 11%. Production activity in this scenario also increases by 24%, reaffirming the crucial role played by NTBs. Extending the AfCFTA's NTB reductions to third countries (Scenario 3) further magnifies the positive impact of the agreement on the bloc's economic outcomes. Exports, tariff revenues, income and production show their highest growth rates when NTBs are reduced on a multilateral basis. Therefore, by reducing NTBs towards non-AfCFTA exporters as well, the bloc's own gains from the AfCFTA are amplified.

How do these different scenarios affect the EU? Across the three simulation exercises, we observe that the impact of the agreement on the EU's aggregate production or output is negligible, which is due to the fact that the AfCFTA economies constitute a minor share of overall EU goods exports. This does not imply, however, that EU exports to AfCFTA economies remain unchanged. When the AfCFTA lowers NTBs on a multilateral basis (scenario 3), EU's aggregate exports to the bloc grow by almost 30%. All EU member states see an expansion of exports to AfCFTA under this scenario. For Germany, export growth due to the AfCFTA is substantial in all key sectors such as motor vehicles (19%), pharmaceuticals (27%) and chemical products (21%). By contrast, intra-AfCFTA tariff elimination alone (Scenario 1) leads to virtually no change in EU exports to AfCFTA economies. Reducing NTBs among AfCFTA countries only (Scenario 2) even has a slightly negative impact on EU exports and imports due to trade diversion resulting from the increased trade within the AfCFTA bloc. In this scenario, AfCFTA economies would source their imports more intensively from within the bloc — especially South Africa — resulting in a drop for EU exports to AfCFTA by 18%.

Public and private action for a successful implementation of AfCFTA

The simulation results show that this ambitious agreement has the potential to address the chronically low levels of intra-African trade observed today and to spur economic growth across African economies. The agreement also presents a valuable opportunity for the EU to stem its declining share in African economies' trade baskets. However, in order to capture the full benefits of economic integration, AfCFTA members must ensure that NTBs are effectively and irreversibly reduced during the agreement's implementation phase, where ever possible in a multilateral fashion.

The gains from the AfCFTA are far from automatic given that reducing NTBs is administratively challenging and also likely to face strong opposition from actors who benefit from the status quo. By assisting in the agreement's implementation, the AfCFTA offers a valuable opportunity for the EU and Germany to demonstrate their support of Africa's economic growth and development. Beside supporting reform-minded African policy makers, European governments and EU institutions can provide technical and financial assistance – possibly within the framework of the existing WTO-led aid-for-trade initiative – to help AfCFTA economies lowering NTBs on a multilateral basis. For instance, sharing best practices, technologies and information to modernize customs procedures in AfCFTA economies can lower costly red tape and documentation burden faced by businesses. Synergies could be achieved by linking this kind of support with the EU's plans for infrastructure investment under the newly launched Global Gateway Initiative. Such EU-level investment in building and maintaining quality infrastructure in Africa would offer additional opportunities for African and European companies by reducing the cost of doing business.

Businesses in the EU and Germany have an important role to play as well. With their considerable knowledge and experience of African markets and persistent trade frictions, they can inform ongoing efforts in both the EU and AfCFTA economies to reduce the most critical NTBs. Multilateral NTB reductions would benefit European companies not only by increasing the overall size of export markets but also by making it easier for them to geographically diversify their exports to Africa, tapping into new markets within the continent.

References

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Authors

Julian Hinz
Kiel Institute for the World Economy (IfW)
University of Bielefeld
julian.Hinz@ifw-kiel.de

Sonali Chowdhry
Kiel Institute for the World Economy (IfW)
European University Institute, Florence

Anna Jacobs
Kiel Institute for the World Economy (IfW)
University of Bielefeld

Rainer Thiele
Kiel Institute for the World Economy (IfW)