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The African Continental Free Trade Area: Potential Economic Impact and Challenges

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SPECIAL NOTE

Although the implementation of some operational aspects of the African Continental Free Trade Area (AfCFTA) have been temporarily suspended, the agreement would be a very important element to support post-pandemic recovery and to foster economic growth in the medium term in sub-Saharan Africa through the creation of larger and more integrated markets and the promotion of intracontinental trade.

Importantly, implementation of the AfCFTA will also reduce uncertainty on trading relations within the continent, which—together with an expanded and more integrated market—would foster both domestic and foreign direct investment and help boost economic activity as countries emerge from the pandemic.

Disclaimer:
This document was prepared before COVID-19 became a global pandemic and resulted in unprecedented economic strains. It, therefore, does not reflect the implications of these developments and related policy priorities. We direct you to the **IMF Covid-19 page** that includes staff recommendations with regard to the COVID-19 global outbreak.

The African Continental Free Trade Area: Potential Economic Impact and Challenges

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CONTENTS

APPENDIX TABLES

ABBREVIATIONS AND ACRONYMS

AfCFTA	African Continental Free Trade Area
AfDB	African Development Bank
AGOA	African Growth and Opportunity Act
AHS	Effectively applied tariff
AMU	Arab Maghreb Union
ASEAN	Association of Southeast Asian Nations
ASYCUDA	Automated System for Customs Data
AU	African Union
AUC	African Union Commission
BIAT	Boosting intra-African trade
CEMAC	Central African Economic and Monetary Community
CEN-SAD	Community of Sahel-Saharan States
CGE	Computable general equilibrium
COMESA	Common Market for Eastern and Southern Africa
DB	Doing business
EAC	East African Community
ECCAS	Economic Community of Central African States
ECOWAS	Economic Community of West African States
EPA	Economic partnership agreement
ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union
GDP	Gross domestic product
GSP	Generalized system of preferences
GVC	Global value chain
IGAD	Intergovernmental Authority on Development
ILO	International Labor Organization
IMF	International Monetary Fund
IOC	Indian Ocean Commission
LAC	Latin America and the Caribbean
LDC	Least-developed country
LPI	Logistics performance index
MFN	Most-favored nation
NTB	Non-tariff barrier
NTM	Non-tariff trade measure

PPP	Purchasing power parity
PTA	Preferential trade arrangement
QR	Quantitative restrictions
REA	Regional economic arrangement
REO	Regional Economic Outlook
SACU	Southern African Customs Union
SADC	Southern African Development Community
SSA	Sub-Saharan Africa
TFTA	Tripartite Free Trade Area
UNCTAD	United Nations Conference on Trade and Development
UNECA	United Nations Economic Commission for Africa
VAT	Value-added tax
WAEMU	West African Economic and Monetary Union
WB	World Bank
WDI	World Development Indicators
WTO	World Trade Organization

EXECUTIVE SUMMARY

In May 2019, African leaders launched the African Continental Free Trade Area (AfCFTA).[1] The corresponding agreement provides a framework for trade liberalization of goods and services and, once fully implemented, is expected to cover all 55 African countries, with an estimated combined GDP of US$2.5 trillion and a population of over 1.2 billion. In terms of population, the AfCFTA will be the largest free trade area in the world.

Trade integration in Africa has long been seen by African policymakers as a mechanism for fostering prosperity. Several trade and regional economic integration groups have been formed over the years. The AfCFTA is the most ambitious initiative in this vein. It can support the realization of the continent's economic promise by helping raise productivity and investment, and thereby increase income levels and reduce poverty.

This Staff Discussion Note assesses income and welfare gains from trade liberalization under the AfCFTA and potential transitional costs for countries participating in the agreement. The note focuses on the potential effects of the AfCFTA on (1) income, welfare, and trade flows; (2) income distribution and employment; and (3) tax revenues. It also discusses key policy reforms needed to maximize the benefits of the AfCFTA.

The AfCFTA has the potential to increase income and welfare significantly for its member countries. Previous studies have estimated that African countries could reap long-term income gains of up to 5 percent from the reduction in trade barriers in the context of the AfCFTA. Our own work focuses on the estimation of changes in welfare and shows gains of up to 2.1 percent for the continent. However, these could be substantially underestimated given the static nature of the model, which does not include potential effects of the agreement on increased investment, innovation, and knowledge diffusion. The bulk of income and welfare gains would come from increased efficiency derived from reduced non-tariff barriers (NTBs), as intraregional import tariffs are already low. In our work, we also find that the largest proportional welfare gains would tend to go to smaller countries with open economies. These would also benefit from positive terms-of-trade changes. Countries starting with higher trade barriers would tend to gain more.

The AfCFTA would also have a strong impact on intraregional trade—which we estimate would expand by more than 80 percent—but relatively limited adverse effects on trade with nonmember countries ("trade diversion"). Increased intraregional trade would add about US$60 billion to African exports and support ongoing diversification efforts.

[1] By late January 2020, 54 (of 55) member countries of the African Union (AU) had signed the AfCFTA agreement. See Appendix II for the full list of signatory countries.

Maximizing potential welfare and income gains from the AfCFTA would require member countries to substantially—but strategically—reduce NTBs. It is important first to remove NTBs that impose the highest trade costs. In this regard, customs and administrative entry procedures, technical barriers to trade, and sanitary and phytosanitary measures should be tackled up-front. It would also be important to improve the quality of trade logistics and close Africa's infrastructure gap, particularly in the areas of ports and road networks.

The implementation of the AfCFTA could result in transitional costs for member countries. These could include (1) tax revenue losses from lower import tariffs; (2) higher income inequality; and (3) higher unemployment, especially where trade liberalization is not accompanied by reforms to make labor markets more flexible and workers more mobile to grasp new opportunities. Given the gradual nature of trade barrier reduction envisaged by the agreement, countries should have time to mitigate these potential costs.

For the continent as a whole, tax revenue losses from the elimination of import tariffs are estimated to be modest. This reflects the low level of effectively applied intraregional import tariffs, the rather modest level of intraregional trade, and a small reduction in imports from the rest of the world. Moreover, any tariff revenue losses are likely to be offset eventually by higher tax revenue from increased consumption and income, as a result of reduced trade barriers, especially NTBs. However, offsetting losses will depend crucially on countries pursuing the necessary steps to lower NTBs.

Limiting negative employment effects will require increasing formal labor market flexibility. Addressing adverse income distribution effects calls for broader and more efficient social safety nets. Training and retraining programs to adapt worker skills to new needs may also be necessary. These reforms should help accommodate the expected labor reallocation across sectors and firms. Increased labor mobility from the implementation of the freedom of movement protocol will also help facilitate adjustment to the reduction in trade barriers.

Improving revenue mobilization will be important. Given that income gains may take time to materialize, the corresponding revenue increases may not compensate for tariff revenue losses in the short term. In addition, higher revenues will also be needed to help finance infrastructure improvements and upgrade social safety nets to mitigate transitional costs from lowering trade barriers.

Finally, upholding the provisions of the agreement will be crucial for the success of the AfCFTA. An institutionally strong and effective AfCFTA secretariat, with the capacity to implement trade rules in line with the text of the agreement, will help build credibility and reduce trade policy uncertainty.