Chapter 4
Revisiting the Case for the CFTA

This chapter revisits the case for the Continental free Trade Area (CFTA). It presents both the theoretical and empirical perspectives that inform the rationale, with a summary of the static and dynamic gains expected of the CFTA. The chapter then briefly looks at how the promotion of intra-African trade is valuable in contributing to Africa's industrialization. It concludes with a progress update on the CFTA negotiations as of July 2017.

Theoretical case

As articulated in *ARIA IV* (ECA, AU, and AfDB, 2010), liberalizing trade between two or more countries generally has positive welfare effects for those countries and leads to economic growth and poverty reduction. But these gains are not automatic. Flanking policies that are trade facilitating and measures to correct distributional distortions are also required (Chapters 5 and 6). Two sets of effects underpin the theory of trade liberalization: the static and the dynamic.

Static effects: Trade creation, trade diversion and modern trade theories

The traditional static effects of free trade areas were first hypothesized by Viner (1950) and concern two concepts related to the efficient allocation of factors of production: trade creation and trade diversion.

Trade creation refers to the increased level of trade that results from the removal of trade barriers within a free trade area. Trade is created when reduced trade barriers enable countries to better express their respective comparative advantage. By focusing their productive factors on where they have a comparative advantage, and trading with each other, countries generate more efficient economic outcomes through better allocation of resources and factors of production.

Trade diversion occurs when trade between countries within a free trade area replaces trade with third countries not party to that free trade area. While this result may benefit certain exporters within the free trade area, overall it is welfare decreasing. Trade is diverted from a more efficient third country in favour of a higher-cost producer from within the free trade area, leading to greater inefficiency and a loss of consumer surplus.

In theory, trade creation and trade diversion imply opposite effects on economic welfare. In practice, the net effect is generally positive (see "Empirical case" below).

Modern trade theories posit additional gains from free trade areas beyond those of the traditional Viner theory of static trade gains, which stem from the implications for producing firms, consumers, climate change and other factors. The following are hypothesized for the CFTA:

- Producers immediately gain from access to: cheaper inputs and intermediary goods from other African countries; a broader variety of inputs and intermediary goods; and larger markets for their products (Amiti and Konings, 2007; Estevadeordal and Taylor, 2013). This enables them to produce more efficiently and competitively and at greater economies of scale.

- Consumers immediately gain from: access to cheaper products from other African countries; and a broader variety of products (Broda and Weinstein, 2004). Both improve consumer welfare.

Continental trade integration also helps eliminate the challenges associated with multiple and overlapping trade agreements in Africa (Krueger and Bhagwati, 1995). More specifically, facilitating trade in food security products helps to mitigate productivity shocks induced by climate change (Ahmed et al., 2012). Where there is a food shortage, alternative food supplies may be more easily and affordably imported. Finally, enhanced access to agricultural inputs and intermediates, including improved seed varieties and machinery, can help producers of food products better adapt to climate change (Maur and Shepherd, 2015).

Dynamic effects

Dynamic gains from free trade areas are realized over the long run and can be more substantial than the static effects. As outlined in *ARIA V* (ECA, AU and AfDB, 2012), the CFTA is likely to realize dynamic gains in several areas, expanded here to seven:

- An enlarged regional market provides incentives for inward foreign direct investment (FDI) and cross-border investment. Most African markets are small, yet many industrial investments require large economies of scale to be profitable. An expanded African market creates the scale necessary for more investment.

- An integrated African market better facilitates competitive interaction between African firms, setting in motion dynamic gains from competition. In contrast, monopolies and oligopolies have little incentive to become more efficient, cut costs or innovate. Yet as monopolistic markets are pervasive across Africa, enabling African businesses to compete in each other's markets can unlock the competitive pressures necessary for long-run productivity growth (Melitz, 2003; Melitz and Ottaviano, 2008).

- Better access to imported inputs and intermediary goods lowers the cost of innovation. Firms may innovate with new combinations and varieties of inputs (Broda, Greenfield and Weinstein, 2006).

- The CFTA may cause trade diversion to African countries at the expense of third countries. While this implies negative static effects (discussed above), it can also increase the relative price of exportables in Africa, stimulating further investment, output and employment in these sectors.

- Greater intra-African trade is expected to extend economic growth and stability to Africa's less developed economies. Integration is likely to stimulate regional growth poles that are capable of generating externalities to less developed African countries. For instance, the formation of regional value chains (RVCs) around the South African automobile sector involves the sourcing of leather seats from Botswana and fabrics from Lesotho. Such spill-overs in regional trade can be particularly beneficial to weaker economies, with some analysis finding that trade with a country's neighbours can reduce the risk of conflict (Calì, 2014).

- Trade diversification and a shift to trade in industrialized goods would improve Africa's long-run growth. Intra-African trade embodies a far larger share of industrial and value-added goods than Africa's trade with the rest of the world. Promoting such trade can generate industrial diversification in Africa and catalyse structural transformation.

- More broadly, regional agreements provide an excellent platform for cooperation and dialogue, including cooperation on infrastructure development, technology transfer, innovation, investment, conflict resolution and peace and security. Neighbouring countries are more likely to have a vested interest in supporting stability in countries with which they share established and valuable trade links.

Empirical case

Free trade areas are usually assessed through one of two approaches: ex-post evaluations that seek to estimate the observed impact of a free trade area using econometrics; or ex-ante evaluations that forecast the impact of a future free trade area using economic models. Here we assess the implications of the CFTA using both approaches, and then present an exposition of intra-African trade flows to reinforce the logic behind the CFTA.

The ex-post empirical literature on free trade areas is mixed. Abrams (1980) and Brada and Mendez (1985) found the European Community (EC) to have an insignificant effect on trade among members, whereas Bergstrand (1985) and Frankel et al. (1995) found significant effects. However, inherent in this analysis is a substantial challenge with endogeneity: The presence, or absence, of a free trade area is not exogenous, but rather the subject of many factors. The result has been to underestimate the positive effect of free trade areas on trade by as much as 75–85 per cent (Baier and Bergstrand, 2007).

Several ex-post studies estimate the long-run effects of a free trade area membership on bilateral trade to be quite large (Egger et al., 2011). Baier and Bergstrand (2007) find that, on average, a free trade area approximately doubles two members' bilateral trade after 10 years. A particular example is the North American Free Trade Agreement (NAFTA) for which Caliendo and Parro (2014) find intra-bloc trade to have increased by 188 per cent for Mexico, 11 per cent for Canada and 41 per cent for the United States.

The ultimate effect of a free trade area depends on the particular characteristics of member countries, including the compatibility of their trade profiles, pre-existing tariff structures and geographical proximity.

While such ex-post analysis of other trade agreements can help guide an indicative estimate for the impact of the CFTA on African trade, more tailored estimates can be gauged by ex-ante economic models.

Mevel and Karingi (2013) model the impact of the CFTA with the removal of all tariffs on trade between African countries. This analysis is then supplemented with the implied effects of improved trade facilitation between African countries using a database on trade costs. Trade creation effects are found to exceed and more than compensate for trade diversion effects. Under the CFTA reform, intra-African trade is estimated to increase by 52.3 per cent ($34.6 billion), compared with a baseline scenario without a CFTA, in 2022. Africa's industrial exports are forecast to enjoy the highest gains, expanding by 53.3 per cent ($27.9 billion). Real wages are estimated to increase for unskilled workers in the agricultural and non-agricultural sectors, as well as for skilled workers, and there is a small shift in employment expected from agricultural to non-agricultural sectors. Flanking the CFTA with trade facilitation measures is found to be important in maximizing the impact of the CFTA on Africa's industrialization and ensuring that all countries gain from the CFTA.

Chauvin et al. (2016) model the cumulative impact of the elimination of tariffs; a 50 per cent reduction in non-tariff measures; and a 30 per cent reduction in transaction costs. They find the short-run impacts in the first years after implementation are generally small but with larger and more positive long-run impacts. By 2027, the CFTA is estimated to increase Africa's welfare by 2.64 per cent. Notably, the reduction in non-tariff measures and transaction costs are found to contribute significantly to improving welfare gains. Chauvin et al. (2016) also link the modelled results to household survey data for a selection of African countries to assess the effect of the CFTA on subnational economic groups, including female or male-headed households, urban or rural groupings, and different income groups. They find the CFTA to have an asymmetric but positive effect on all the subnational groups, with the particular groups that gain most varying by country.

Three important messages derive from these studies. First, the importance of complementary policies that go beyond tariff reductions, which alone imply small and asymmetric impacts on African countries. Complementary policies are necessary to maximize the gains of the CFTA but also to ensure that its benefits are shared equally to produce a win-win outcome for all countries. Such measures include the reduction of non-tariff measures and transaction costs, such as those associated with improved regulatory transparency, harmonization of sanitary and phyto-sanitary regulations, the accreditation and mutual recognition procedures for technical barriers to trade and improved administrative conditions in customs. With the inclusion of such measures, welfare gains are enjoyed by all African countries (Chapter 6).

Second, the most important gains from the CFTA will be realized over the long run as the agreement contributes to the economic restructuring of African sectors towards more productive industrialized and export sectors, and to improved investments. (As detailed in Chapter 6, several measures can help ease this structural adjustment.)

Third, the recognition that such studies likely underemphasize the range of benefits derived from the CFTA, as modelling exercises struggle to capture and quantify the full gamut of CFTA benefits. They frequently overlook gains such as those facilitating trade in food security products, improving the stability of fragile countries, enhancing firms' access to inputs and intermediary goods, reducing the cost of innovation, improving intra-African competition, addressing the challenges linked to overlapping African trade agreements and RECs and providing a platform for cooperation and dialogue more broadly.

The CFTA, Africa's trade flows and industrialization

The prevailing story of Africa's exports since 2000 has been that of the strong impact of the commodities super-cycle. As Figure 4.1 shows, the bulk of Africa's impressive almost-three-fold increase in exports, from $194 billion in 2000 to $544 billion in 2014, is due mostly to the expansion of extractive exports and the commodity price boom.[1] This has contributed to Africa's headline growth figures but has not been conducive to the economic transformation Africa requires to industrialize and realize long-run sustainable growth.

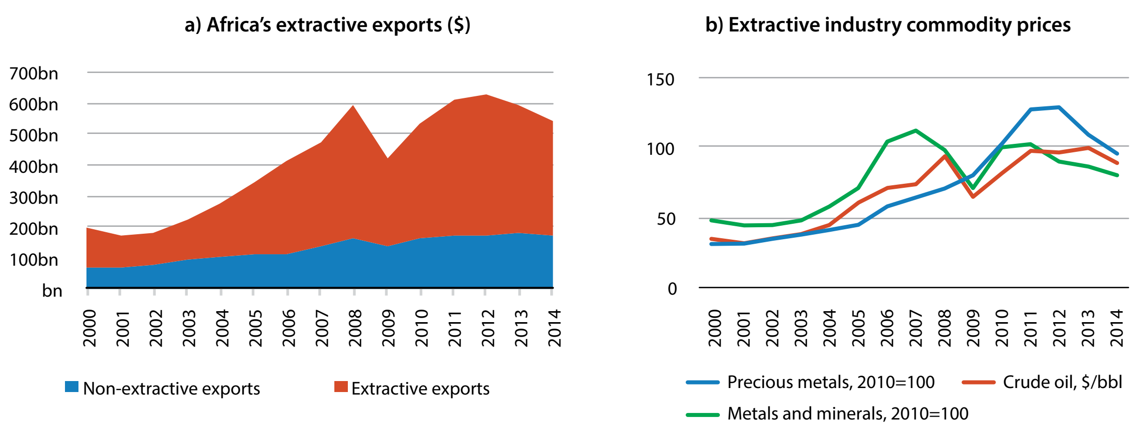
In sharp contrast is the composition of Africa's intra-African trade. Extractive composition of intra-African trade shows that intra-African trade comprises a disproportionately large share of non-extractive exports. Looking at the most recent three-year average, this included $17 billion in processed industrial supplies, $10 billion in capital goods, $8 billion in processed food and beverages, $7 billion in transport equipment, another $7 billion in consumer goods, $4 billion in primary food and beverages and $2 billion in primary industrial supplies.

The growth of intra-African trade has helped to promote Africa's industrial export sectors since 2000. Despite amounting to just 18 per cent of Africa's total exports, intra-African exports have accounted for 57 per cent of the growth in Africa's exports of capital goods, 51 per cent of processed food and beverages, 46 per cent of consumer goods, 45 per cent of transport equipment, and 44 per cent of processed industrial supplies (Share of Africa's export growth in non-extractive export categories, intra-African vs the rest of the world). (Chapter 9 provides a more detailed assessment of Africa's trading relationship with the rest of the world (RoW), by presenting disaggregated data.)

The exceptional value of this intra-African trade for Africa's industrialized economic transformation provides the foundational logic behind the CFTA (Box 4.1). The fundamental rationale of the CFTA is to promote this trade through the removal of tariff and non-tariff barriers.

Figure 4.1

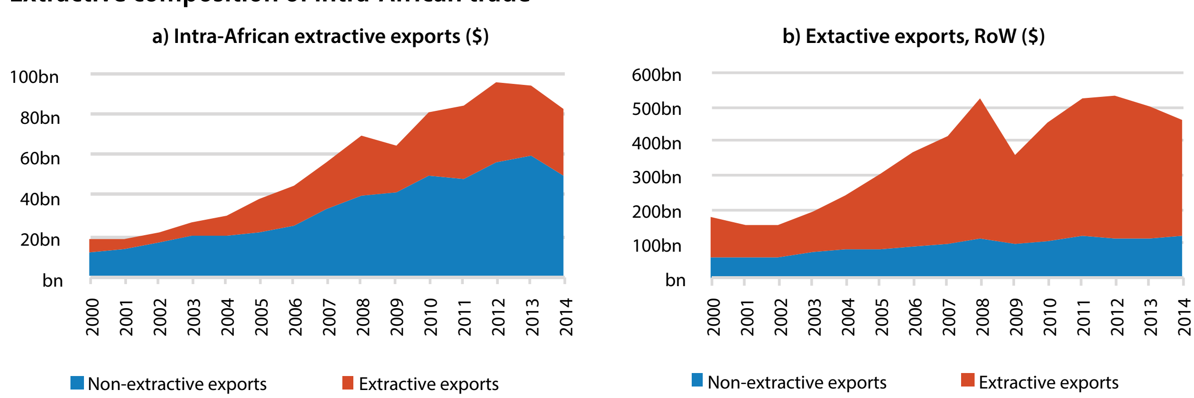
Africa's extractive industry exports and world commodity prices



Source: ECA calculations using CEPII-BACI trade dataset and World Bank Commodities Market Data.

Figure 4.2

Extractive composition of intra-African trade



Source: ECA calculations using CEPII-BACI trade dataset and World Bank Commodities Market Data.

Table 4.1

Share of Africa's export growth in non-extractive export categories, intra-African vs the rest of the world

	Import category	Share of export growth attributable to each market (%)	
		Intra-Africa	Rest of the world
Food and beverages	Primary	18	82
	Processed	51	49
Industrial supplies	Primary	15	85
	Processed	44	56
	Capital goods	57	43
	Transport equipment	45	55
	Consumer goods	46	54

Source: CEPII's BACI dataset. Values compare the export growth between three-year averages of 1998–2000 and 2012–2014, and calculate the proportion of export growth attributable to each market such that $Share\ Attributable_{i,j} = (Exp_{i,j,t} - Exp_{i,j,t-1})/(Total_{i,t} - Total_{i,t-1})$ *where i is the export category, j is the buying market, and t is the period. Exp is the value of exports of category i to market j while Total is the total value of exports from Africa of product j.*

Box 4.1

Using the CFTA as a vehicle for industrialization

The imperative of advancing Africa's industrialization should be kept in mind throughout the CFTA negotiation process. In particular, the final CFTA Agreement should aim to:

- Commit member states to an ambitious liberalization agenda for trade in goods, reflecting the importance of securing market access for African countries in other African countries, which is crucial for boosting intra-African trade in intermediates, developing manufacturing RVCs and reducing Africa's import bill for processed foods.
- Include provisions consistent with the imperative of industrial development under the CFTA industrial pillar. The continentally agreed programme for the Accelerated Industrial Development of Africa should serve as a building block for the industrial pillar, particularly its six objectives to integrate industrialization in national development policies; maximize the use of local productive capacities and inputs; add value to abundant natural resources; develop small-scale and rural industries; take maximum advantage of Africa's partnerships to enable the transfer of technology; and establish and strengthen financial and capital markets.
- Include a framework agreement on trade in services to help to boost intra-African trade in services, harness the capacities of African services suppliers and ensure competitively priced service inputs for African manufacturers. These can be achieved through progressive liberalization that consolidates and builds on existing achievements of the RECs.
- Contain a framework agreement on investment that provides common rules for state parties in introducing incentives for attracting investments to accelerate development and industrialization. This will help to avoid any race to the bottom and recognizes government procurement as a key policy tool for promoting the use of local suppliers.
- Include provisions for the free movement of economic operators (traders, business persons, investors, etc.) involved in trade in goods and services and in investment. This element is needed to transform the opportunities provided through liberalized trade in goods, services and investment and to maximize the use of regional productive capacities in industrial production.
- Harmonize product standards, conformity assessment and accreditation practices to achieve mutual product recognition and facilitate intra-African trade in manufactured goods, particularly agro-processed foods.
- Include flexible rules of origin with generous cumulation requirements to encourage local and regional processing and the development of African industrial supply chains.

Source: Sommer and Luke (2017).

Progress update: CFTA negotiations and scope

Negotiations for establishing the CFTA were launched in June 2015 by the Heads of State and Government of the AU at the 26th Ordinary Session of the AU Assembly in Johannesburg, South Africa. Th AU Assembly decision launching the CFTA urged the participation of all regional economic communities (RECs) and member states and called on the African Union Commission (AUC), UN Economic Commission for Africa (ECA), African Development Bank (AfDB), African Export-Import Bank and other development partners for support, with the aim to operationalize the CFTA by the end of 2017.

Following the launch, six meetings of the CFTA Negotiating Forum were held by July 2017, supported by eight meetings of the Continental Task Force, and two meetings each of the Technical Working Groups, the Committee of Senior Trade Officials, and the African Ministers of Trade (The remainder of 2017 will see these bodies convening frequently, with a further two meetings of the Negotiating Forum. Table 4.2 summarizes negotiation progress as of July 2017.).

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As detailed in Chapter 9, free trade agreements can take many forms: Potential CFTA configurations were outlined in *ARIA VI* (ECA, AU, and AfDB, 2015). The CFTA negotiations are in progress and so it would be premature to provide a detailed outline of current expectations as to form and content.

On the basis of the draft of the negotiating text, and the negotiations and technical work undertaken, the envisaged scope of the CFTA covers agreements on trade in goods, services, investment, and rules and procedures on dispute settlement (Table 4.3). The constituent parts of these agreements and their appendices are expected to cover a range of provisions that aim to facilitate trade; reduce transaction costs; and provide exceptions, flexibilities and safeguards for vulnerable groups and countries in challenging circumstances. It is anticipated that agreements on intellectual property rights and competition policy will be tackled in phase 2 of the CFTA negotiations (Chapter 10). Crucially, countries are aligning their interests in a comprehensive agreement that achieves substantially more than tariff reductions and that offers safeguards and flexibilities, which are important for ensuring that the gains from the CFTA are maximized and shared equitably (discussed further in Chapter 5).

Though there remain substantive topics to discuss, the negotiations have achieved considerable momentum and build on a long history of African integration (Table

Figure 4.3

Institutional framework for the CFTA negotiations

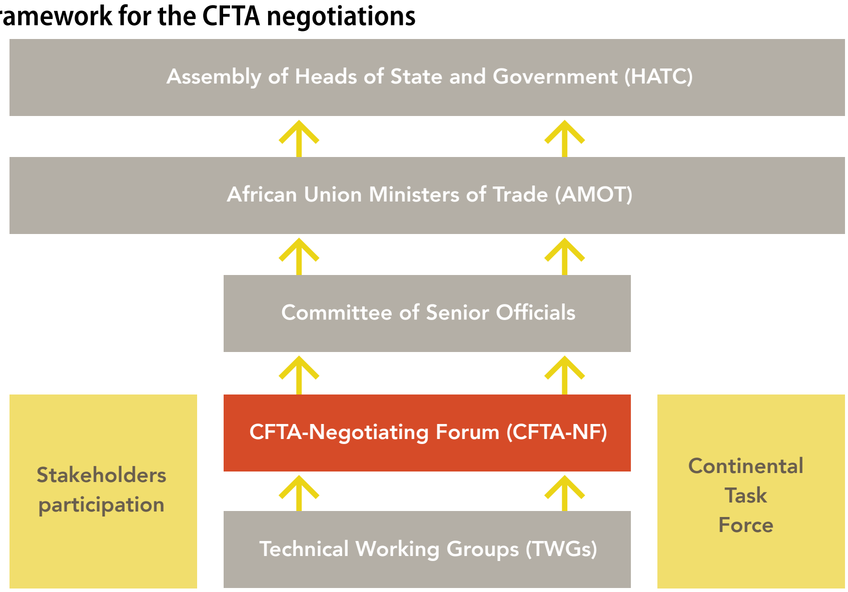

Table 4.2

Negotiation progress

Negotiating forum	Timeline	Progress
1	February, 2016	Adoption of the Rules of Procedure.
2	May, 2016	Adoption of 12 Negotiating Principles and Terms of Reference for the Services Technical Working Group.
3	October, 2016	Adoption of remaining Terms of Reference for Technical Working Groups and opening discussions of Negotiating Modalities.
4	December, 2016	Further discussions on Negotiating Modalities and commissioning of technical studies on services modalities and goods modalities.
5	February, 2017	Review of modality options for goods and services and agreement on a range of modality elements. A draft text of the CFTA was presented and agreed to as a starting point for the text-based negotiations. This draft is to be refined with technical inputs at the Technical Working Groups.
6	July, 2017	Refined modalities for both goods and services, including agreement on a 90% level of ambition for goods, the timeframe for liberalization, qualifications for sensitive products, a procedure for reviewing excluded products, and the scope for special and differential treatment to support less-developed state parties as well as a common approach for progressive services liberalization.

Table 4.3

Envisaged scope of the CFTA*

Protocol Establishing the CFTA	• Annex A: Agreement on Trade in Goods
	• Annex B: Agreement on Trade in Services
	• Annex C: Agreement on Investment
	• Annex D: Rules and Procedures on Dispute Settlement
Parts and appendices under negotiation	• Liberalization of trade (imports and export duties, NTBs and rules of origin)
	• Movement of persons and economic operators
	• Customs cooperation, trade facilitation and transit
	• NTBs
	• Technical barriers to trade
	• Sanitary and phyto-sanitary measures
	• Trade remedies and safeguards
	• Exceptions (general and security exceptions, balance of payments)
	• Agriculture, fisheries and food security
	• Technical assistance, capacity building and cooperation
	• Complementary policies (special export zones, capacity building and cooperation
Phase 2 negotiations	• Agreement on Intellectual Property Rights
	• Agreement on Competition Policy

** As of July, 2017.*

Table 4.4

CFTA in the context of African integration

1963	Integration of African continent an aspiration at inauguration of the OAU
1979	Common African market first mentioned in the Monrovia Declaration
1980	Common market elaborated in the Lagos Plan of Action
1991	Continental Customs Union put forward in the Abuja Treaty
2000	AU established with integration as an objective
2012	AU Assembly adopts BIAT Action Plan and roadmap for establishing a CFTA
2015	African Tripartite Free Trade Area Signed
2015	CFTA negotiations launched by the AU Assembly
2016	AU Summit reaffirms its commitment to fast tracking the CFTA by 2017
2017	AU Heads of State and Government mandate President Mahamadou Issoufou of the Republic of Niger to champion the process of the CFTA to ensure that the 2017 deadline is reached

4.4). The CFTA has a notable commitment at the highest policy-making levels. The AU Summit in Kigali in 2017 reaffirmed the commitment of the AU Heads of State and Government to fast track the CFTA. Designing the CFTA at the technical working groups and negotiating forum meetings, and ensuring its effective implementation, are now the critical tasks at hand. As foreseen in the Abuja Treaty, the integration process is to culminate in the African Economic Community.

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Endnotes

1 Extractive exports here include petroleum oils (SITC 33), gas (SITC 34), non-ferrous metals (SITC 68), metalliferous ores and metal scrap (SITC 28), crude fertilizers and minerals (SITC 27), coal, coke and briquettes (SITC 32), as well as the remaining precious metals in HS 71, uranium (HS 2844), and the basic iron products of HS7201–HS7206.