

# Making the AfCFTA work for 'The Africa We Want'

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## **Abstract**

The African Continental Free Trade Agreement (AfCFTA) has been touted as an economic and globalization game changer because it has the potential to transform African economies and significantly raise Africa's share of global trade to position the region as an increasingly dynamic force in the international arena. However, to realize this potential, African countries must actively carry out complementary structural and policy reforms to foster long-term peace and security, address the supply-side constraints and mitigate the short-term fiscal adjustment costs of the trade agreement to set the continental trade-integration project on a successful implementation path for a win-win continental trade-integration outcome. This paper reviews the potential development impact of the AfCFTA and provides a comprehensive analysis of reforms and programs required to ensure the agreement's successful implementation.

“Without a doubt, if Africa becomes economically integrated, it will be a global leader and the largest economic region in the world.”—Professor Jeffrey Sachs<sup>1</sup>

## I. Introduction

In the 1970s, Europe was the prime destination for African goods, receiving more than 60 percent of the continent’s total exports, while Africa as a whole received only about 7 percent of its own exports. Although intra-African trade has increased in recent years, Africa still trades more with the rest of the world than with itself and compares unfavorably with other regions in intra-regional trade intensity.<sup>2</sup> The highly extroverted and geographical concentration of African trade partly reflects the stickiness and lingering effects of the colonial economy, which forbade horizontal trade between African colonies and exclusively promoted vertical trade between the colonies and their respective colonial powers in the North (Fofack, 2019a).

So entrenched were these historical and colonial ties that, for a long time in the post-independence era, African economic growth remained highly correlated with business cycles in Europe—hence the saying, “When Europe sneezes from a dust of recession, Africa catches an economic cold.” Even as the old colonial trade patterns are on a decelerating trend, aggregate headline numbers mask important variations across the region. The colonial umbilical cords linking African countries to their historical trading partners in Europe remain very strong for a subset of countries, especially members of the Arab Maghreb Union and the Community of Sahel-Saharan States. Indeed, in 2018, on average, member countries of the Arab Maghreb Union sourced about 56 percent of their aggregate imports of goods from Europe and only about 5 percent from Africa during the decade ending. Similarly, member countries of the Community of Sahel-Saharan States sourced more than 34 percent of total imports of goods from Europe and only about 7 percent from the rest of the continent during the same period (Muchanga, 2019).<sup>3</sup>

At the continental level, however, the decreasing intensity of trade between Africa and its historical partners reflects the acceleration of globalization and emerging growth opportunities, and new trade corridors in the developing South. These new trade opportunities shook the post-colonial distributional bias and broadened the geographical landscape and direction of African trade, especially following China’s accession to the World Trade Organization in 2001. About a decade later, China became a major driver of global growth and trade, and, since 2009, it has been Africa’s single largest trading partner. China’s meteoric rise has also accelerated the growth of both South-South and Africa-South trade. The former now accounts for more than 43 percent of world trade, and the latter accounts for more than 55.6 percent of total African trade—up from 1970 figures of 22.8 percent and 17.1 percent, respectively. New trading partners and emerging growth opportunities in North America also shifted

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1 Sachs made this statement during the second edition of the Afreximbank’s Babacar Ndiaye Lecture, held in Bali, Indonesia, during the World Bank-IMF Annual Meetings in October 2018. For more details, see Afreximbank (2019a).

2 While intra-African trade has increased in recent years to account for more than 15.5 percent of total African trade, it still pales in comparison to intra-regional trade performance in Europe (67 percent) and Asia (54 percent).

3 Member countries of the Arab Maghreb Union are Algeria, Libya, Mauritania, and Tunisia; members of the Community of Sahel-Saharan States are Benin, Burkina Faso, Cape Verde, Central African Republic, Chad, Djibouti, Egypt, Eritrea, The Gambia, Libya, Mali, Mauritania, Morocco, Niger, Nigeria, Senegal, Somalia, Sudan, Togo, and Tunisia.

the geographical distribution of African trade, most notably under the African Growth and Opportunity Act.<sup>4</sup>

However, these developments did not necessarily boost Africa's integration into the global economy or shift the composition of its trade (Afreximbank, 2019b). In fact, the relative contribution of Africa to global trade fell to about 2.8 percent in 2019, down from 4.3 percent in 1970, perhaps reflecting the significant technological changes in the composition and drivers of global trade and growth (Afreximbank, 2020). Primary commodities and natural resources still account for the lion's share of African trade in a rapidly changing international economic environment where global trade is driven by manufactured goods with increasing technological content. Furthermore, they have been source of recurrent risks and vectors of growth volatility because of commodity price cycles and the long-term deterioration in commodity terms of trade (Fofack, 2015, 2019a).

A potential economic and globalization game changer in this scenario is the African Continental Free Trade Agreement (AfCFTA), which entered into force on May 30, 2019, as the world's largest free trade area since the establishment of the General Agreement on Tariffs and Trade (GATT) more than 70 years ago.<sup>5</sup> The continental trade integration reform is one of the flagship projects under the African Union's Agenda 2063—The Africa We Want—and could transform the structure of African economies and significantly raise the continent's share of global trade (Fofack, 2018a; IMF, 2019).<sup>6</sup> This paper reviews the potential development impact of the AfCFTA in diversifying the sources of growth and trade. It also provides a comprehensive analysis of policy reforms and programs required to ensure the agreement's successful implementation.

To date, the focus of the AfCFTA has largely been on eliminating nontariff barriers. However, several other measures are essential, including mitigating short-term fiscal adjustment costs and reviving national development banks, to inject the patient capital needed to sustain the process of structural transformation and tackle supply-side bottlenecks; strengthening the security and development nexus to consistently optimize the allocation of scarce resources is essential for both structural transformation and long-term peace and security. These steps will ensure that the rules of origin, which are at the heart of the African continental trade reform, are an industrialization accelerator and not a binding constraint to growth in the short term. Effectively carrying out these policy reforms is a precondition for success and will ensure that the AfCFTA, which has created the largest free trade area in the world, delivers a win-win outcome throughout its implementation.

The rest of the paper is organized as follows. Section 2 assesses the potential development impact of the AfCFTA on the structural transformation of African economies and the diversification of their exports. The next two sections review the critical challenges—both policy and structural—to successful implementation of the AfCFTA and highlight policy options for addressing these challenges to set the region on an irreversible path toward economic growth and effective integration into global value chains. Section 3 focuses on the first set of challenges, especially options for addressing the supply-side constraints, infrastructure bottlenecks and nontariff barriers. Section 4 focuses on the financing of the AfCFTA, specifically financing the transformation of African economies. Section 5 outlines

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4 The African Growth and Opportunity Act establishes the basis for a nonreciprocal trade preference program that provides duty-free treatment for U.S. imports of certain products from eligible African countries. It has been the cornerstone of U.S. engagement with Africa since 2000 (Liser, 2018).

5 The AfCFTA entered into force 30 days after earning the required 22 ratifications by member governments.

6 The flagship projects of Agenda 2063 refer to the 14 programs and initiatives that have been identified as critical for accelerating Africa's economic growth and structural transformation, as well as its cultural renaissance. For more details on these projects, see <https://au.int/en/agenda2063/flagship-projects>.

options for mitigating the fiscal adjustment costs associated with tariffs elimination. Section 6 reviews the security and development nexus and its implications in a region where the recurrence of conflicts has been a major source of instability and constraint to regional integration. Section 7 concludes.

## 2. Assessing the game-changing nature of the AfCFTA

The AfCFTA's growth prospects and development impact generated using Computable General Equilibrium models that allow for trade-diverting and trade-creating effects of tariff and nontariff shocks by exploiting countries' comparative advantage and price adjustments are positive and significant (Saygili et al., 2018, IMF 2019). Aggregate headline estimates and forecasts derived from these models show that the average gross domestic product (GDP) of the region would grow by 0.66 to 0.97 percent annually, and employment would grow by just as much. Real wages would increase across the board for both skilled and unskilled workers, with the latter registering a much higher growth rate, in an apparent shift toward a more inclusive growth model (Saygili et al., 2018; Lunenborg, 2019). The potential impacts at the household and corporate levels are also significant, with estimates showing that by 2030, the fully integrated market of 1.7 billion people will have an estimated \$6.7 trillion of combined consumer and business spending (Signé, 2018).

Intra-African trade is set to enjoy its most impressive rate of expansion during implementation of the AfCFTA. Preliminary estimates show that cross-border trade could increase by \$34.6 billion (52 percent) by the end of the second decade, and a further \$85 billion if trade facilitation, rather than just tariff liberalization, is undertaken as a complementary measure during implementation (UNECA, 2015). Empirical results from gravity models (which are based on a partial equilibrium approach and do not account for feedback and interaction effects) are consistent as well, showing that tariff reductions associated with the AfCFTA would significantly boost cross-border trade within the region (Afreximbank, 2018; IMF, 2019).

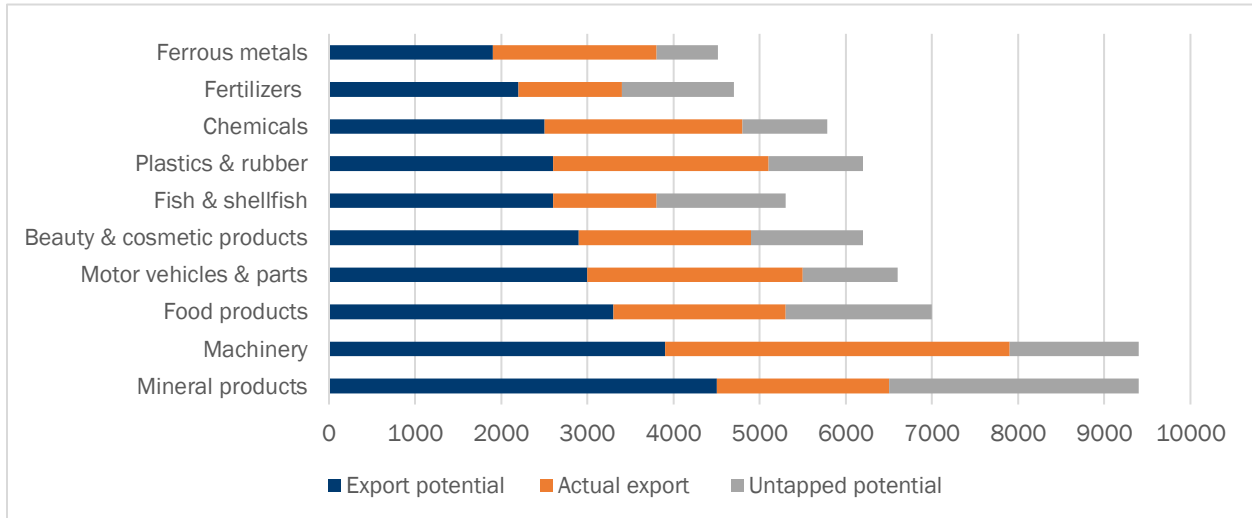
Furthermore, empirical evidence from the most recent African trade data shows that industrial products and manufactured goods exhibit the greatest intra-African trade potential (Afreximbank, 2020). These newly revealed drivers of intra-African trade include mineral products, machinery, motor vehicles and parts, chemicals, and fertilizers (Figure 1). This finding suggests that prospects for further expanding intra-regional trade and accelerating the process of industrialization are highly correlated. They could both act as major catalysts during the implementation of the AfCFTA, which is set to fundamentally shift the balance of potential trade relationships across the region, especially with the expected improvement in the landscape of African competitiveness and productivity (Fofack, 2018b).<sup>7</sup>

These preliminary results are consistent with economic theory, which has identified several channels through which trade integration can drive growth and accelerate income convergence across countries. The first of these channels is efficiency gains through the trade creation effects in a static setting. Trade creation refers to the positive growth spillover effects resulting from a free trade agreement and inherent increasing economies of scale that produce improved allocation of resources and reduced costs of doing business, which in turn ease trade and investment flows and drive growth.

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<sup>7</sup> Despite efforts in recent decades to deepen economic integration, the realization of Africa's trade potential has been constrained by trade regimes that have remained largely governed either by general trade protocols or most-favored nation rates, both of which cover more than 70 percent of total intra-African trade.

**Figure 1: Products with greatest intra-African export potential (millions of USD)**



Source: ITC Export Potential Map, Afreximbank Research.

The second channel is derived from the dynamic comparative advantage theory. Through the dynamic effects of trade integration, countries specialize in the production of certain goods and services and drive long-run growth by shifting the resources to the most efficient sectors where they enjoy comparative and competitive advantages. The third channel is the international product cycle, which enables the production of certain goods previously manufactured by more advanced economies to migrate to less developed countries to take advantage of lower production cost structures and improved competitiveness (Krugman, 1979; Rodriguez and Rodrik, 2001; Busse and Koniger, 2012).

However, product migration can also ignite the process of global technological convergence by expanding the volume of trade and increasing the diffusion of more advanced production technologies. A shift in the African production structure, triggered by increasing opportunities for economies of scale, could facilitate the diffusion of knowledge and foster technological progress that eventually would accelerate the optimization of production processes and the development of new products. In this context, the AfCFTA, which is set to fundamentally shift African patterns of trade and growth toward increased levels of industrial products and manufactured goods, is also likely to catalyze technology transfer and the development of national and regional value chains.

In addition to increasing industrial productive capacities to meet the growing demand for manufactured goods that dominate intra-African trade, the AfCFTA will facilitate the development of national, regional, and continental value chains that have been the key drivers of growth and efficient vectors of integration in existing global value chains (GVC) and more generally into the global economy. Globally, firms integrated in GVC account for over 80 percent of total trade even though they represent only about 15 percent of all trading firms. Furthermore, a 10-percent increase in GVC participation is estimated to boost per capita income growth by more than 10 percent, about twice as much as standard trade (World Bank, 2020). In other words, because industrialization and intra-regional trade

are mutually reinforcing, the technological content of intra-African trade, which has industrial products and manufactured goods, could accelerate even more during the implementation of the AfCFTA.<sup>8</sup>

Trade integration has worked very well for other regions where it has set countries on an irreversible path toward export diversification and income convergence. Despite the fiscal and sovereign debt crisis that afflicted countries in southern Europe after the 2008-2009 global financial crisis, trade integration has been a driver of growth and income convergence within the European Union (Draghi, 2019; Buti, 2020). The same argument can be made regarding the growth and development impact of regional integration in Asia, where it has contributed to a rapid expansion and an interconnection of regional value chains as well as a dramatic reduction in poverty. The process of regional integration promoted under the Association of Southern Asian Nations (ASEAN) also has narrowed the region's technological gaps with advanced economies and accelerated the process of income convergence between Asian emerging market economies and advanced economies.

In Africa, the benefits of trade integration are likely to be just as significant if the AfCFTA is successfully implemented. Until now, the fragmentation of African markets has resulted in costly diseconomies of scale and pulled down the economic potential of the whole continent. The economic benefits and returns of the trade agreement could include rationalizing the existing eight overlapping regional economic communities. Also, the expected increased risk-adjusted returns associated with economies of scale under the AfCFTA would create the conditions for large-scale investment in the region. Furthermore, the diversification of sources of growth associated with a shift in the composition of foreign direct investment would also increase the sophistication of exports and improve the overall balance of payments for countries across Africa. If the AfCFTA's promise is fulfilled, it could end forever the recurrence of balance of payment crises that have exposed countries to the diktat of the Washington Consensus for decades.

The question, therefore, is no longer whether the AfCFTA will transform the region's economies by accelerating the development of national and regional value chains to expand industrial production and boost both extra- and intra-African trade, but when this will happen. The launch of the trade agreement's operational phase in July 2019<sup>9</sup> shifted the focus toward its implementation to deliver The Africa We Want, a fully integrated, industrialized, prosperous, and peaceful continent on an irreversible path toward robust economic growth and sustainable development, and representing an increasingly dynamic force in the international arena.

### **3. Fast-tracking implementation of the AfCFTA: Lifting the constraints**

The growth and development potential of the AfCFTA are indeed significant, given the agreement's potential to set the region on path toward structural transformation and sustainable per-capita income growth that, in the long run, could accelerate the process of global income convergence and reduction of global income inequality. However, realizing this potential requires overcoming several challenges. This section identifies and describes three key challenges: supply-side constraints, the burden of

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<sup>8</sup> A growing number of empirical studies shows that when African countries trade with themselves, they exchange more manufactured and processed goods, engaged in more knowledge and technology transfers as well as creation of value (UNECA, 2018; Afreximbank, 2019b).

<sup>9</sup> This took place during an African Union Extraordinary Summit in Niamey, Niger on July 7, 2019. Trading under the AfCFTA was set to commence on July 1, 2020, but was postponed to January 1, 2021 following the outbreak of the COVID-19 pandemic and subsequent containment measures—including border closures, lockdowns, and social distancing—adopted by countries to stem the spread of the virus.



nontariff barriers, and infrastructure constraints. It also outlines policy options and reforms to alleviate these constraints and fast-track implementation of the AfCFTA.

### 3.1 Overcoming supply-side constraints to boost African trade

Realizing the growth and development potential associated with the AfCFTA requires strong political commitment to implement the policy and structural reforms that can address the myriad supply-side constraints confronting the region. These constraints are visible across product, labor, and financial markets as well as in the realm of technology and innovation. They have made it difficult for African production to keep pace with the changing nature of global demand and the household consumption basket, which, thanks to globalization, includes more manufactured goods and industrial products with increasing technological content.

Even though these tradable goods with increasing technological content account for the bulk of African imports—both extra- and intra-African imports and the household consumption basket—the region has failed to produce them. This trend led most African countries to rely on imports as short-term alternatives to deficient domestic production infrastructure and undiversified sources of growth. However, over time, the excessive reliance on imports of manufactured goods became a permanent feature of African trade and economic development, undermining the growth of intra-African trade and exacerbating the risk of external imbalances and debt overhang, most recently illustrated by macroeconomic fallout from the COVID-19 pandemic downturn—heightening liquidity constraints and balance of payment pressures (Fofack, 2015, 2020).

The institutional and economic incentives to address these supply-side constraints and boost industrial production are contained in the rules of origin that define the types of goods and value addition that must occur within the AfCFTA member countries in order for them to benefit from preferential market access under the agreement (UNCTAD, 2019a). Hence, enforcement of the rules of origin is the centerpiece of continental trade-integration reform: If the rules are not strictly enforced, imports of cheaper goods from other regions traded under African labels will sustain the current growth trajectory of transit trade, undermining the process of industrialization and ultimately the AfCFTA's development impact.<sup>10</sup>

Another issue associated with the weak enforcement of rules of origin is trade deflection, which allows third parties to reroute their exports to the member nation with the lowest external trade barriers to gain access to the broader market. While trade deflection may increase overall African trade, as more countries take advantage of lower overall total costs of goods, it could also undermine the process of industrialization within the region, especially when the deflection is made from a more efficient third trade partner in favor of a higher-cost producing countries.

For instance, countries not eligible for the African Growth and Opportunity Act (AGOA) eyeing the U.S. market have used eligible African nations as re-export platform for transit trade in the past since the implementation of AGOA provides duty-free treatment of imports of certain goods from eligible African countries to the United States. The risk of trade deflection is still possible under the AfCFTA, because

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<sup>10</sup> These concerns were raised by major African manufacturers' associations and partly motivated the decision by some governments to delay their endorsement of the AfCFTA. This is particularly the case for Nigeria, home of the region's largest market and among the last to sign the AfCFTA, because the Nigerian Manufacturers Association believed that joining the AfCFTA could undercut ongoing efforts to stimulate the local manufacturing sector, if other non-member countries of the agreement could circumvent the rules of origin to dump cheap goods in the country.

the continental trade integration reform does not preclude an AfCFTA member state from entering into a trade agreement with a third country.

Conversely, if strict enforcement of the same rules of origin is not followed by the rapid development of productive capacities to expand industrial output and manufactured goods, it could ironically become a major constraint to economic growth rather than an accelerator of industrialization. In particular, this situation may likely arise if the small- and medium-sized enterprises (SMEs) across the region are not able to meet the value-added threshold required to receive AfCFTA tariff preferences (Signé and van der Ven, 2019). In this context, African countries must simultaneously expand their industrial productive capacities to address the supply-side constraints that have been key drivers of structural balance of payment crises and could well become the Achilles' heel that would derail the AfCFTA (Fofack, 2018a). This is particularly important because the quest for industrialization and diversification of sources of growth, which have eluded Africa for decades, predated the AfCFTA.

Therefore, concerted efforts at the national, regional, and continental levels to foster vibrant public-private partnerships and effective implementation of policy and structural reforms are essential in the short and medium terms. It is equally important to raise the levels of labor productivity and credit available to the private sector in order to expand industrial production and manufacturing capacities. These goals should be the centerpiece of the continental trade-integration reform. To support implementation of that reform, policymakers must prioritize aligning financial sector incentives with growth and structural transformation objectives, because, for decades, financial repression and credit rationing have constrained private investment and growth. Recent strong steps by the Central Bank of Nigeria towards such a goal include increasing financing of the real economy by limiting the capacity of banks to put customers' deposits into high-yielding government securities and by raising the threshold of loan-to-deposit ratio to at least 65 percent.

African banks' support of the private sector, especially SMEs, has been very weak, with most highly liquid financial institutions preferring to invest in risk-free government securities. In general, total outstanding loans have been extremely low across the region, and significantly less than averages in other regions of the world.<sup>11</sup> Even in Nigeria, one of the continent's largest economies, domestic credit extended to the private sector by banks and other financial institutions has accounted for only 15.6 percent of GDP—significantly lower than in other countries. For example, in the United Kingdom, this domestic credit accounts for 134.2 percent and in Turkey, 65.7 percent. In only a few African countries—most notably Morocco, Namibia, South Africa, and Tunisia—domestic credit to the private sector exceeds 50 percent of GDP (Figure 2).

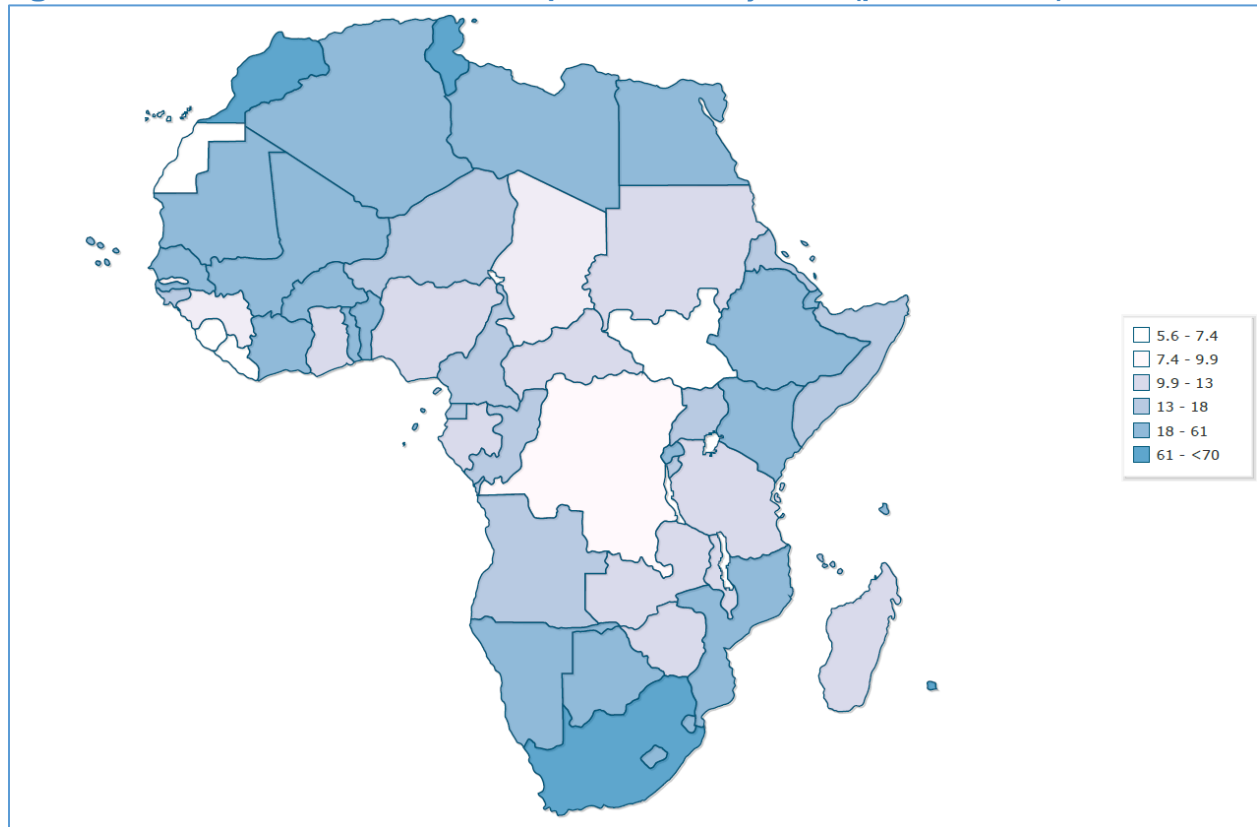
These trade reforms should also prioritize early liberalization of products that can provide a natural ladder for diversification of sources of growth and export, including labor-intensive manufacturing and agricultural products, for which African countries have a comparative advantage. Preliminary results show that the AfCFTA could raise intra-African trade in agricultural products by between 20 and 30 percent and also significantly improve the balance of payments in a region where food import bills have become a major driver of external imbalances. However, expanding employment opportunities in the manufacturing and agricultural sectors requires improving the quality of and access to a wide range of ancillary services—including accounting, financial services, communication, and

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<sup>11</sup> Average credit to the private sector in African countries, expressed as a percentage of GDP, varies between a low of 5.5 percent in Sierra Leone and a high of 67.9 percent in Tunisia. The rates are much higher in Asia, Europe, and North America, for example, exceeding 161 percent in China, 111 percent in Spain, and 124.4 percent in Canada.

transportation—that provide the basic infrastructure for cross-border exchange of information and trade in goods.

**Figure 2: Domestic credit extended to the private sector by banks (percent of GDP)**



Source: World Bank World Development Indicators, Afreximbank Research.

Therefore, it is particularly important to hasten negotiations planned during the second phase of the AfCFTA to adopt schedules on specific commitments to trade in services and protocols on investment, competition policy, and intellectual property rights. The investment protocol would go a long way in strengthening the investment and trade linkages and shift the composition of foreign direct investment to accelerate the diversification of African exports away from commodities, which have been the main channels of growth volatility and recurrent balance of payment crises. Prioritizing a greater disclosure of investment-related information, harmonizing investment laws and regulation, and otherwise facilitating investment could tackle barriers to inflows of foreign direct investment and catalyze the injection of patient capital that the region needs to drive industrialization.

Empirical evidence from other regions of the world shows that the growth of intra-regional investment has been a major catalyst for intra-regional trade and macroeconomic stability. In the Asia and Pacific region, growing trade and investment linkages have supported the development of regional value chains and strengthened the foundation for economic resilience in the face of both market and policy-induced uncertainties in today's global economic and trade policy environment (ADB, 2017).<sup>12</sup> AfCFTA

<sup>12</sup> Bucking the global trend of declining foreign direct investment flows to developing countries, robust intra-Asian investment flows have supported high investment rates and mitigated the exposure of the region to global volatility. This has made it the world's fastest-growing region over the last three decades.

reforms should also emphasize the liberalization of intermediate goods and promote intermediate trade, to accelerate the development of regional and continental value chains and thereby strengthen both forward and backward linkages.

### **3.2 Closing the infrastructure deficit to boost the AfCFTA's development impact**

Overcoming the deficit of infrastructure, which has been a major constraint to both economic growth and intra-African trade expansion, will become ever more critical during the implementation of the AfCFTA. Such an effort will include both physical and digital infrastructure, which, in the current fragmented African markets, have been major constraints to economic transformation and industrial production, as well as to the distribution of goods. As investors look to capitalize on economies of scale offered by the AfCFTA, nothing is as pressing as integrating markets and improving connectivity.

Infrastructure has been the bedrock of connectivity and productivity growth in other countries and regions of the world, enabling them to fully leverage their resource endowment and better integrate into global supply and industrial value chains. To a large extent, the low level of industrial output and cross-border trade in Africa reflects the challenges faced by African businesses, which have been hobbled by a chronic deficit of infrastructure across the board, including road transportation networks, railways, energy, irrigation, and research.

More than 97 percent of Africa's infrastructure deficit is in trade-enabling infrastructure (in energy, transportation, and logistics). Shortcomings in the power sector alone are estimated to drain between 2 and 4 percent of African countries' GDP every year, reflecting the cross-cutting nature of energy in powering growth across all sectors of economic activity (Eberhard et al., 2011). Closing the infrastructure deficit in these critical sectors would not only increase industrial productivity; it would also ensure that efficient and cost-effective distribution channels are in place to facilitate the flows of goods and services across the new continental free trade area.

In the short term, the historical burden of the infrastructure deficit could become even more constraining. Cross-border infrastructure is already required to connect African producers and consumers within and between countries, and within and between regional economic communities, to reap the full benefit of the economies of scale associated with the AfCFTA. Even though the ongoing process of digital transformation is reducing economic distance between countries, bilateral trade is still negatively correlated with distance—even after controlling for income levels, economic size, and internet penetration (Egger, 2008; Le, 2017). Furthermore, despite the increasing shift toward digitalization, not all digitally traded goods are digitally delivered. Therefore, a combination of poor physical and digital infrastructure will remain a dragging factor for growth and trade across Africa and could seriously undermine the development impact of the AfCFTA—especially given that more than 30 percent of African countries are landlocked.

In the agriculture sector, for instance, developing reliable transportation networks and logistics to connect regions with surplus production, with regions experiencing food deficits, has the potential to raise incomes of rural farmers and increase intra-regional trade. But, in the absence of reliable infrastructure networks and logistics, the surplus production could result in post-harvest losses and further deter any prospects for boosting agricultural productivity. Likewise, solid irrigation infrastructure has the potential to significantly raise agricultural productivity and boost intra-African trade in a region that is highly exposed to the growing economic and social costs of climate change. However, in the absence of such infrastructure, the region's countries have been reduced to spending more on food imports every year, even though they collectively contain more than 60 percent of the

world's remaining arable land. Most recent annual estimates put Africa's consolidated food import bill at more than \$90 billion in 2018 (World Bank, 2019).<sup>13</sup> Food imports have become a major driver of external imbalances, and the adverse impact on countries' balance of payments could become unsustainable, especially with the projected population growth.

Africa's infrastructure gap is at the intersection of the continent's supply-side constraints in both the production space, most notably through productivity enhancement and output expansion, and the logistics space, through the delivery of goods and services within and between countries. Preliminary estimates suggest that improving the quality of Africa's infrastructure to meet global standards would significantly boost intra-African trade. If spillover effects in productivity growth and diversification of sources of growth are included in the analysis, the impact is even greater (IMF, 2019).

Against this background, the AfCFTA has generated renewed interest in the development of infrastructure across the region, as both a productivity enhancer and an asset class. In an era of zero-lower-bound quantitative easing, in which yields on top-rated fixed-income assets are falling, a growing number of institutional investors have been diversifying their portfolios to achieve higher inflation-adjusted returns on long-term infrastructure investments offering stable returns over longer periods. The expected productivity gains and returns associated with increasing economies of scale are likely to further increase the returns on infrastructure investment and to enhance the viability of large-scale infrastructure projects, which, in the past, have been perceived as too risky in a highly fragmented market setting.

One example of a large-scale infrastructure project that is increasingly viewed as a sound investment is the Grand Inga Dam on the Congo River in the Democratic Republic of the Congo, which would be the world's largest hydropower project. It would have the capacity to engineer low-cost energy industrialization, while at the same time fostering long-term peace and security in the region. Like the European Coal and Steel Community, which provided the foundation for the European Union integration project, the dam would foster regional trade in power, perhaps emerging as a powerful force for market integration and efficient resource allocation within Africa. Furthermore, it has tremendous potential for productivity growth and industrial development, as it could reliably provide clean and low-cost energy to power industries and support the manufacturing revolution needed to address the supply-side constraints during implementation of the AfCFTA.

Furthermore, the Inga Dam—one of the 14 continental flagship projects under the African Union's Agenda 2063—could generate 43,200 megawatts of power to support current regional power pools and their combined service to increase access to clean and affordable electricity. Feasibility studies show that increasing the production capacity of the proposed dam to about 12,000 megawatts in the first phase of the project would lower the costs of energy by \$.03 to \$.05/kilowatt-hour, a significantly more competitive cost structure than the average tariff of \$.10/kilowatt-hour across the continent. However, the Inga Dam and several other major regional and transnational infrastructure projects have been under preparation for decades and are not likely to be delivered anytime soon given the large infrastructure finance gaps confronting the region, among other challenges.

Therefore, both governments and development finance institutions are increasingly considering industrial parks (IPs) and special economic zones (SEZs) as short-term alternatives to promote industrialization and address supply-side bottlenecks under infrastructure constraint throughout

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<sup>13</sup> Interestingly, the food import bill incurred by Africa annually has now exceeded the total amount of resources flowing into the continent in the form of overseas development assistance.

Africa. These geographically defined areas serve as development magnets that shift the distribution and allocation of foreign direct investment away from primary commodities and natural resources towards manufacturing and industrial production. According to the UNCTAD World Investment Report, the number of African SEZs has grown significantly over the last decade—237 were operating in 2019, along with 200 single-enterprise power zones (so-called “free points”).<sup>14</sup>

Overall, 38 African countries host SEZs, led largely by Kenya, Nigeria, and Ethiopia, which together account for about half. The concept of the SEZ draws on lessons from Asian emerging developing market economies that have successfully engineered the process of structural transformation in a context of surplus labor and scarce capital. These short-term alternatives are already sustaining robust economic growth rates and contributing to the diversification of sources of growth and trade in a few African countries that are among the world’s fastest-growing economies (IMF, 2018).<sup>15</sup>

Ethiopia, which is actively pursuing an Asian-style industrialization policy, has drawn on industrial parks (specifically Eastern Industry Zones and Hawassa Industrial Park) to diversify its export base. As a result of its Asian-style industrialization model, Ethiopia has become one of the leading beneficiaries of the preferential trade program extended by the U.S. government to African exporters under the AGOA. Similarly, the Kigali Special Economic Zone (KSEZ) has enabled Rwanda, another of the continent’s fastest-growing economies, to attract multinational companies in sectors ranging from automotive and aeronautics manufacturing to textile and garments. Firms in KSEZ are enjoying significantly higher growth rates, with a 206 percent increase in sales and a 201 percent increase in value added compared to similar firms located outside the zone (UNCTAD, 2019b).

Although initially conceived as short-term alternatives to prohibitively large costs of financing infrastructure, the development impacts and long-term benefits of SEZs for accelerated structural transformation and welfare improvement have been significant. In Asia, the world’s fastest-growing region of the world for the last few decades, the expansion of labor-intensive employment opportunities in the manufacturing sector provided the foundation for long-term growth and ultimately drove wealth accumulation. Over time, these short-term alternatives have diversified the sources of growth, and thereby broadened the tax base and generated additional fiscal revenues to sustainably finance long-term infrastructure projects without exposing countries to a risk of debt overhang.

Another type of infrastructure that requires sustained investment and commitment from African leaders during the implementation of the AfCFTA is “soft” infrastructure, especially the development of technical and engineering skills, which are crucial for driving the process of industrialization and expanding manufacturing output. In a rapidly changing global economy in which technological advances and innovation have become the major drivers of competitiveness and global growth, moving up the development ladder has become highly correlated with upward movement along global value chains.<sup>16</sup> This new development paradigm of the continuously increasing technological content of trade has accelerated dramatically in the last few decades with the deepening process of globalization. The trend is irreversible, and the most successful countries are reforming their academic and research institutions to equip their citizens with must-have science and engineering skills.

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<sup>14</sup> See UNCTAD 2019, “World Investment Report 2019: Special Economic Zones”, United Nations Conference on Trade and Development (UNCTAD).

<sup>15</sup> These countries include Ethiopia, Ghana, Rwanda, and Tanzania, which all have experienced average economic growth rates higher than 6 percent for the last two years.

<sup>16</sup> A brain drain from Africa has exacerbated the shortage of these skills. A short-term response to skill gaps could be a combination of training programs and reliance on expertise in the diaspora (Easterly and Nyarko, 2009).

### 3.3 Eliminating nontariff barriers to increase cross-border trade

Phasing out nontariff barriers is the third challenge that African governments must address to boost the development impact of the AfCFTA. While the agreement has prioritized the removal of physical and fiscal barriers to trade, evidence increasingly shows that the persistence of nontariff barriers that have stifled cross-border trade in the past could continue to be a major impediment during implementation of the trade agreement. Already, lessons from integration at the level of Africa's regional economic communities (RECs) show that the impact of tariff reduction on cross-border trade has been very limited, suggesting that the elimination of fiscal barriers is not the most important binding constraint to intra-African trade. This finding is especially true in a challenging institutional environment in which overlapping memberships in the regional economic communities have hindered trade standardization and enforcement mechanisms.

With a few exceptions, most notably the Southern African Development Community (SADC), where cross-border imports has been relatively high (19 percent of total imports), cross-border imports from other RECs have remained dismally low, even though carried out either on a tariff-free basis or via relatively low applied tariffs on imports. One of the most illustrative examples is the Central African Economic and Monetary Community (CEMAC), where cross-border imports within RECs have accounted for less than 0.2 percent of total imports for member countries. At the continental level, the CEMAC member countries, which are still trading more with Europe than with each other, accounted for less than 5 percent of total intra-African trade in 2019.<sup>17</sup> In contrast, as the most dynamic regional economic community SADC accounted for a healthy 56.6 percent of total intra-African trade. However, even the two most performing RECs on intra-regional trade (SADC and EAC) are still trading more with the rest of the rest world, sourcing more than 70 percent and 85 percent, respectively, of their goods outside Africa (Figure 3).

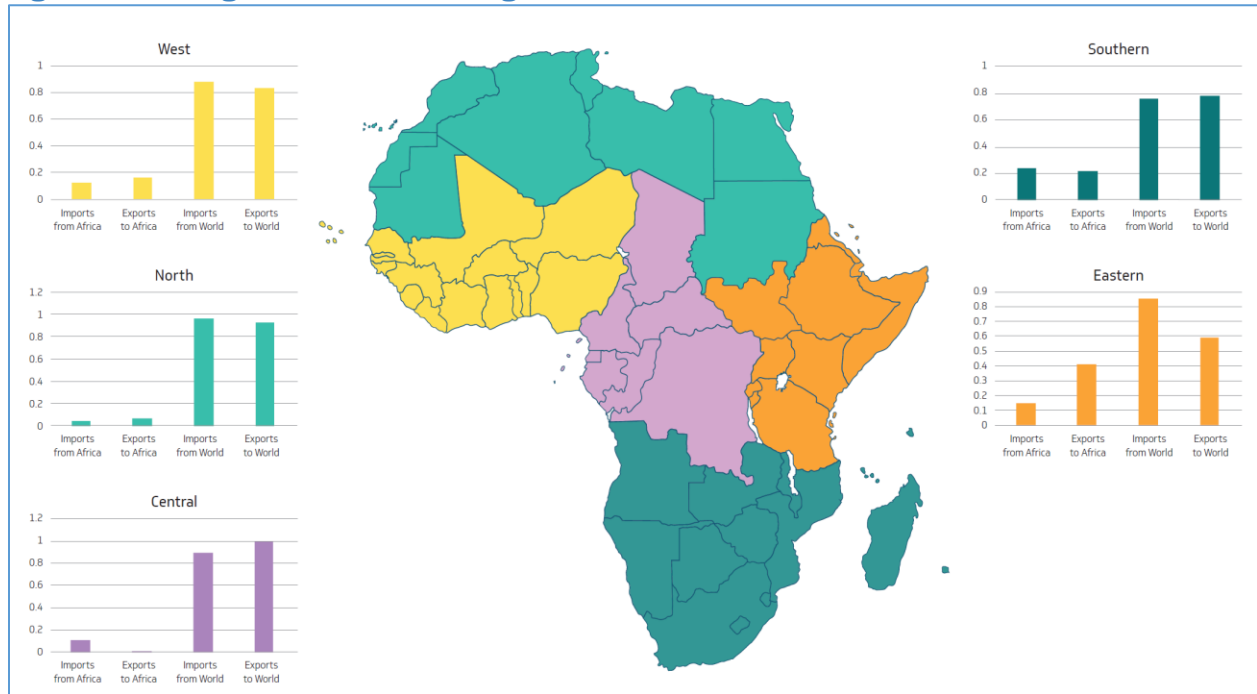
Empirical evidence from several variations of gravity models and principal component analysis contrasting the effects of both tariff and nontariff policy levers on intra-regional trade in Africa point to a much higher impact of the latter. Eliminating tariffs on 90 percent of existing intra-regional trade flows would significantly increase regional trade over time. However, policies addressing nontariff bottlenecks such as customs services, clearance procedures, freight services and warehousing management could be up to four times more effective in boosting intra-African trade (IMF, 2019). This suggests that a combination of policy reforms eliminating both tariff and nontariff barriers would have a much higher development impact and raise the growth and development dividends of the AfCFTA, measured in terms of cross-border trade and investment or trade intensity of growth.

To shed more light on the potential trade impact associated with elimination of nontariff barriers, the International Monetary Fund (IMF) carried out a comprehensive study to identify the set of nontariff factors that best explain intra-regional trade gaps in Africa. That study singled out four factors as the most significant: the quality of infrastructure, the availability of credit to the private sector, the business environment, and trade logistics such as customs-related services, clearance procedures, harmonization of transport procedures and regulations, and brokerage services (IMF, 2019). Of these four, trade logistics emerged as the most significant nontariff barrier stifling the expansion of intra-regional trade.

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17 The share of goods imported by these countries from the European Union is more than 32 percent.

**Figure 3: Intra-regional trade across regional economic communities**



Source: Afreximbank Research.

Hypothetically, improving the quality of trade logistics in Africa to the global average level (an improvement of about 19 percent) would lower the costs of cross-border movement of goods and increase intra-African trade by 12 percent (IMF, 2019). These results are not surprising, especially given that low-income economies and geographically disadvantaged countries face disproportionately higher transportation costs as a result of poor roads and other infrastructure. In Africa, these costs are significantly higher than the averages in other regions of the developing world, driven by the disproportionately large number of landlocked countries. The poor quality of transport infrastructure accounts for 40 percent of logistics costs in coastal countries and 60 percent in landlocked countries (UNCTAD, 2017; AU, 2019a).<sup>18</sup>

Infrastructure was singled out as the second most significant nontariff bottleneck to trade flows within the region in a recent IMF study (2019). A counterfactual analysis in that study suggests that, if all other factors remain the same, improving the quality of Africa’s infrastructure to the global average (an improvement of about 40 percent) would spur a 7 percent increase in intra-regional trade flows. Though much lower than the potential gains associated with improved trade logistics, better-quality infrastructure has tremendous implications for productivity growth and for lifting supply-side constraints. Indeed, improved infrastructure could indirectly boost intra-African trade, perhaps resulting in much greater aggregate intra-African trade and trade-induced growth than suggested by empirical results from a partial equilibrium analysis.

In the short term, the costs of nontariff barriers pose significant obstacles to both trade and economic growth for most countries across the region and could undermine implementation of the AfCFTA. Therefore, the growing number of steps taken at national, regional, and continental levels to address

<sup>18</sup> On average, these costs represent more than 77 percent of the value of exports in landlocked developing countries (UNCTAD 2017).



constraints emanating from nontariff barriers is very encouraging. Such moves include the recently announced plans by the government of Rwanda to fully automate the clearance of exports and imports and reduce the time taken to clear cargos, with the goal of boosting revenue, reducing international trade costs, and increasing the flows of taxable goods (Afreximbank, 2019b).

At the regional level, the implementation of the EAC's Single Customs Territory has reduced transit times and costs for goods entering the East African Community (EAC) through Mombasa by approximately 50 percent and 30 percent, respectively (AU, 2019a). At the continental level, the AU-led Online Mechanism on Monitoring, Reporting, and Elimination of Nontariff Barriers is one of the key supporting instruments to accelerate implementation of the AfCFTA. The primary catalytic role of the mechanism is to introduce efficiency in the management and resolution of non-tariff barriers and other obstacles to trade with a view to eliminating them.

## 4. Financing the transformation of African economies to fast-track implementation of the AfCFTA

In addition to addressing infrastructure challenges and removing nontariff barriers, successful implementation of the AfCFTA requires a sustainable increase in the rate of growth of the patient capital to expand industrial production and processing capacities. This capital is needed to accelerate the diversification of sources of growth and trade across the region, and ultimately to transform African economies in the medium and long terms. This section outlines options for financing the transformation of African economies and for sustaining the momentum for trade reform during the implementation of the AfCFTA. In particular, it emphasizes the revival of national development banks.

Effectively mobilizing the resources required to accelerate the process of industrialization and transformation of African economies is the fourth challenge that must be overcome to ensure a successful implementation of the AfCFTA in the short and medium term, and more generally to deliver "The Africa We Want" in the long term. The constraints in access to finance faced by African traders are the same as those faced by African entrepreneurs and SMEs. Unlike in other regions of the world, SMEs in Africa have been confronted with tightened financing conditions, under what has become a time-invariant use of financial repression and credit rationing as a monetary policy rule (Fofack and Ndikumana, 2014; Fofack, 2018a). In practice, this time-invariant financial repression as a monetary policy regime has been reflected in the dismally low level of domestic credit to the private sector.

Most countries across the region have felt the development impacts of that time-invariant monetary policy rule, particularly in the area of investment, and especially SME finance and trade finance.<sup>19</sup> Regarding the latter, the costs of that time-invariant quantitative tightening monetary policy rule are compounded by the colonial legacy of an extroverted development model of resource extraction and trade finance. Under that model, the limited amount of resources directed by both international and domestic banks toward the financing of African trade have been heavily skewed toward extra-African trade, in contrast to patterns in other regions of the world.

According to the African Development Bank (AfDB) *Trade Finance in Africa* survey report, bank-intermediated trade finance devoted to financing intra-African trade has remained consistently low

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<sup>19</sup> Trade finance gaps are significant across Africa, with annual estimates exceeding \$90 billion on average (AfDB, 2017).

across Africa (AfDB, 2017). Even though trade finance continues to be a relatively low-risk activity for commercial banks across the region, the share of bank-intermediated trade finance devoted to intra-African trade has, on average, accounted for less than 20 percent of their trade finance portfolios. This trend suggests that intra-African trade has been relegated to a lower-priority status, despite its potential for economic transformation and macroeconomic stability as an efficient absorber of adverse global shocks (Brixiova et al., 2015).

To be sure, the amount of resources allocated to financing intra-regional trade may be correlated with the intensity of cross-border trade itself, though the direction of causality is not clear. Still, the fact that year after year, surveys of investors and traders have mentioned the shortage of finance—reflected in a consistently large trade finance gap—as a major constraint to trade expansion clearly suggests that the burden of finance is shaping the intensity of trade within the region (AfDB 2017). Thus, increasing the resources allocated to intra-African trade finance to rebalance the African trade finance landscape can boost regional integration.

A recent review of policy options for sustaining the financing of African trade argues for financial deepening and integration within the region, with a focus on the development of a regional financial infrastructure for cross-border trade and investment. Key components of that financial infrastructure would include harmonization of regional payment systems to further facilitate cross-border payments, creation of swap arrangements between African central banks, and a multi-currency clearing center in the region, to reduce the risks from trading in several different currencies (IMF, 2019). The review equally stresses the need to strengthen the coordination of a growing number of pan-African banks that are playing an increasingly important role in financing cross-border investment and trade.<sup>20</sup>

Several regional initiatives are already underway to integrate African exchanges, with the aim of achieving a greater alignment between fragmented capital markets and equally fragmented markets for goods and services, as part of broader efforts to uniformly defragment African economies (Fofack, 2019b; OMFIF, 2019). These initiatives aim to transform African capital markets into effective instruments for global competition for capital. They include: (1) the African Exchanges Linkage project to harmonize trading rules as well as settlement cycles and listing fees across Africa's leading exchanges; and (2) the pan-African Stock Exchange spearheaded by the African Securities and Exchange Association, to accelerate financial integration with the goal of increasing the diversification of asset allocation across geographies and sectors, while addressing the liquidity challenges that have consistently constrained the promotion of African trade and investment.<sup>21</sup>

In southern Africa, the Committee of Southern African Development Stock Exchanges is fostering the integration of capital markets among SADC member countries by promoting the harmonization of trading, clearance, and settlement procedures. The economic dividends of these regional and continental reforms of the financial sector are already being felt in southern Africa, where the recent increase of cross-border trade has been largely attributed to the harmonization of listing requirements by SADC exchanges and the SADC Integrated Regional Settlement System (SIRESS). Ultimately,

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20 Since the retreat of several global banks from Africa in the wake of the global financial crisis and the subsequent implementation of stringent compliance and regulatory regimes, African banks with a continental footprint have been playing an important role in financing trade and the provision of correspondent banking services. Some of these institutions include Ecobank Group, with a footprint in 36 African countries; United Bank of Africa, in 20 countries; and Afriland First Bank Group, in 11 countries. Also, the African Export-Import Bank has increased the level of resources directed toward financing intra-African trade and has significantly expanded its correspondent banking services and support to its trade finance Intermediaries throughout the continent.

21 Despite the acceleration of GDP growth over the last two decades, domestic savings remain very low and capital markets small and illiquid. More than 20 percent of African stock markets show low overall liquidity; 15 countries have equity market turnover of less than 10 percent of market capitalization.

SIRESS will reduce overreliance on international networks such as SWIFT and correspondent banks for regional cross-border transfers, and potentially ease financial leakages. Similarly, the development of the regional sovereign bond market in the West African Economic and Monetary Union has the potential to improve the coordination of security issuances and market oversight. This will eventually enhance the ability of member states to finance their operations on local financial markets.

The ongoing process of financial market integration at the regional level is providing governments with a wider market for their securities as well as increasing the prospects and options for extending maturities while lowering yields, compared with national issuances. Furthermore, these regional initiatives are mitigating the liquidity constraints and exchange risks that have been major challenges to long-run growth and macroeconomic stability. The development impact of financial market integration will be further enhanced by digitalization which has the potential to catalyze the pooling of resources towards long-term investment.

A growing number of institutions are already drawing on digital transformation to foster financial integration and boost trade. For example, the African Export-Import Bank has designed its Pan-African Payment and Settlement System (PAPSS) to resolve the challenges associated with the fragmented and costly cross-border payment and settlement infrastructure inherited from the colonial era. The new system is fully aligned with the IMF's farsighted recommendation to increase the use of local currencies in cross-border trade to reduce both transaction costs and liquidity constraints. It also has the potential to significantly raise efficiency by disintermediating correspondent banking relationships for intra-African trade payment flows, while at the same time integrating formal and informal trade to boost both intra-African trade and overall African trade (IMF, 2019).<sup>22</sup> Furthermore, it could catalyze collaboration between intra-African asset allocators and reduce overall currency risks.

Similar ongoing regional initiatives are set to reduce the costs of trading across the continent and to increase liquidity to boost the confidence of investors—by improving payment systems, reducing liquidity constraints and exchange risks, and drawing on digital transformation and the integration of African capital markets and derivative exchanges. However, growing and transforming African trade may also require more activist government officials at the helm of policymaking, at both the national and the continental levels. Informed policymaking is required to address both short- and long-term financing needs in a way that mitigates the risks of maturity mismatch and the procyclicality of the financial system, which remains highly correlated with commodity price cycles in most natural resource-rich and commodity-dependent economies.

Consider the common use of procyclicality of financing as a risk-mitigating option in the face of recurrent business cycles and deterioration of commodity terms of trade triggered by global volatility: Commercial banks and investors often extend more credits during booms but ration it during economic crises, ironically when finance is most needed to spur growth and prevent long-lasting damage to the economy during downturns. Furthermore, and irrespective of the business cycle and economic environment, most commercial banks that engage in procyclicality have refrained from injecting the patient capital needed to transform African economies and diversify their exports. Instead, most banks have opted for short-term finance and self-liquidating trade finance transactions, which have maintained the patterns of trade inherited from the colonial era.

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<sup>22</sup> Preliminary estimates show that the PAPSS could significantly cut transaction costs associated with the current inefficient payment system, in the range of \$5 billion annually.

Across Africa, this risk-averse model underpinned by procyclicality of financing and preference for self-liquidity financial transactions has deterred commercial banks from long-term investment projects, even where capital markets have established themselves as efficient vectors for financial intermediation. Perhaps the chronic deficit of long-term financing points to the inability of these capital markets to act as an effective alternative to public capital, by pooling resources for long-term development, or to fill the vacuum created by the withdrawal of policy lending institutions, chiefly national development banks in the age of financial deregulation at the height of the free market and neoliberalism ideology.

Deregulation and reforms of the financial sector during the global integration of financial markets and capital account liberalization championed by the IMF under the Washington Consensus in the 1990s led to the closure of most national development banks in most regions across the developing world, including Africa. Under the efficient market hypothesis, the theory was that the rise of capital markets would enable the pooling of financial resources and global savings to sustain the growth of long-term lending and expand industrial production capacities.

The role of national development banks has been to provide this type of finance for long-term investment, public infrastructure, small and medium-sized enterprises, and the development of new industries in strategic sectors. But more than fostering innovation and the growth of start-ups, the financing provided by national development banks has sustained countries on a long-run growth path. The counter-cyclical support provided by these institutions has enabled countries to mitigate adverse shocks during downturns—averting and reducing the length of recessions—and increase prosperity in upturns.

These banks' active role in East Asia provided the financial incentives to crowd-in private capital and investment and emerged as a major catalyst in converging living standards in that region. Through their countercyclical interventions, they also mitigated the risks associated with business cycle and global volatility to keep countries on a long-run trend GDP growth. According to World Bank data, during the 2007-2009 global financial crisis, national development banks increased their lending by more than 36 percent, to \$1.58 trillion, when commercial banks were freezing lending, including inter-banks loans.

The premature closure of national development banks in the developing world had significant implications for trade and capital accumulation, especially for economies in the early stages of development. In most cases, the shutdown of these banks led to a sharp decline of concessional financing. This decline, in turn, led to a dramatic fall in gross capital formation, which set countries on a premature path toward deindustrialization (Rodrik, 2015; Griffith-Jones and Ocampo, 2018; AU, 2019a).

Moreover, the premature decision to close these banks or drastically withdraw concessional government funds left a major vacuum in the financing of economic development, especially in low-income countries (Griffith-Jones and Ocampo, 2018). In Africa, their closure was associated with a dramatic fall in gross fixed capital formation and a sharp drop in industrial output. Between 1990 and 2014, the share of manufacturing in total value added decreased by 6.2 percentage points for the subset of countries in sub-Saharan Africa and by about 3 percentage points for countries in North Africa (UNCTAD, 2016).

For the few countries with reliable data on the finance allocated by national development banks, evidence clearly shows that these institutions were major stakeholders in the process of economic

transformation, in both developed and developing countries. In particular, they played a key role in the promotion of financial innovation and technological advances in China and Germany—the two countries that have relied on a strong manufacturing base to engineer and sustain a successful model of export-led growth. During the first decade of the new millennium (2000-10), the outstanding loans of national development banks as a percentage of GDP rose from 6.2 percent to 11.2 percent in China, and from 8.5 percent to 15.9 percent in Germany (Nayyar, 2018).

Defying the global trend of a decreasing role of national development banks, the governments of China and Germany strengthened their policy lending institutions—China Development Bank (CDB) and Kreditanstalt für Wiederaufbau (KfW)—to support and expand their industrial production and manufacturing sectors. In the last few decades, CDB and KfW balance sheets have increased significantly, in part reflecting the capacity of these institutions to expand their portfolios and drive the process of innovation by investing in new sectors and industries with strong growth potential. For instance, KfW, which has become Germany's second-largest bank, has been a critical source of domestic capital for small businesses, clean energy, and innovation. It is leading the promotion of energy-efficient housing and standards in Germany and positioning itself as a global leader in the process of energy transition.

India presents a contrasting story. National development banks were established in that country to lead the process of industrialization and structural transformation in the aftermath of its independence. These banks were the major drivers of capital formation and long-term growth in India in the decades following the 1970s. As a proportion of gross capital formation in the manufacturing sector, their total disbursement rose from 10 percent in 1970-1971 to 50 percent in 2000-2001 (Nayyar, 2018). After most of these banks were closed in the early 2000s, their outstanding loans dropped from 7.4 percent to 0.8 percent of GDP in recent years.<sup>23</sup>

If the closure of most national development banks in Africa is not the ultimate cause of a chronic infrastructure deficit and stubbornly weak industrial output, it certainly contributed to the large and persistent infrastructure finance gap that is stifling the process of economic transformation and productivity growth throughout the region. Indeed, a recently released manuscript on the future of national development banks indicates that the challenge of sustaining the growth of long-term financing for development is not specific to Africa, as witnessed by the example of India and some countries in Latin America (Griffith-Jones and Ocampo, 2018).

Given these developments, leaders in a growing number of countries, especially in emerging developing market economies, are calling for the revival of public investment banks to support the injection of the patient capital needed to accelerate the process of industrialization and expand the scope of manufacturing output. In addition to enhancing the process of industrialization and value addition, the revitalization of national development banks is also particularly important for catalyzing private investment. Drawing on a wide-range of risk-mitigating instruments and financial products, including underwriting of political risk and their loss-absorbing capacity these banks have the potential to de-risk investment and crowd in private financial resources that are critically needed for the development of industrial and manufacturing capacities to sustainably address supply-side constraints and boost both extra- and intra-African trade.

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<sup>23</sup> Several policy lending institutions were established in India to drive the process of economic transformation and included both term-lending institutions (Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Industrial Development Bank of India, State Financial Corporations and State Industrial Development Corporations), and insurance providing guarantees (Life Insurance Corporation of India, Unit Trust of India, and General Insurance Corporation of India).

As the lifeblood of growth and trade, finance may be the fuel needed to power the diversification of sources of growth and trade during implementation of the AfCFTA—especially in a region where per-capita income and domestic savings remain very low and capital markets are largely too embryonic to effectively carry out the needed financial intermediation functions. National development banks should be part of the emerging financial infrastructure for economic transformation, because both short- and long-term finance is required to reduce the risks of maturity mismatch and procyclicality of financing to keep countries on a path of fiscal and debt sustainability during the implementation of the continental trade-integration reform.

## 5. Mitigating the AfCFTA fiscal adjustment costs

Empirical evidence shows that the long-term benefits of the AfCFTA for the region at large are significant and largely outweigh the potential losses associated with the continental trade-integration reform. But the short-term adjustment costs could undermine the support for the reform at the national level—especially among the most vulnerable member countries—and ultimately derail implementation during the second and most critical phase of the project. These short-term costs are varied and include both private adjustment costs through labor and capital markets and public sector adjustment costs through fiscal channels.

At a time when countries are shifting their focus toward implementation of the AfCFTA—trading under the agreement will start on January 1, 2021<sup>24</sup>—mitigating these fiscal costs at the outset is crucial to sustaining the reform momentum at the continental level and consolidating the foundation of broad-based support the agreement has generated. Overcoming this fifth challenge may involve stepping up ongoing efforts to boost domestic resource mobilization and provide short-term financial incentives to compensate for gaps in revenues in the most vulnerable countries and create the conditions for a win-win continental trade-integration outcome.

Although most of the emphasis to date has been put on fiscal adjustment costs—most notably in the form of expected fiscal revenue losses and inherent budgetary pressures—the AfCFTA is likely to entail additional expenses. Such expenses may result from the reallocation of resources arising from the implementation of a free trade agreement and include the training and retraining costs associated with the obsolescence of skills in labor markets. Transitional costs of shifting capital across sectors, as well as the suboptimal utilization of existing capital stock and productive equipment that could undermine economic growth are also possible expenses (Saygili (2018), Lunenburg, 2019).

Public and private adjustment costs are not completely segregated. The former could be exacerbated by the rising costs of social safety nets and entitlement benefits, especially if the reform is associated with short-term spikes in unemployment in countries where cross-sectoral labor mobility is limited, or if trade liberalization is not accompanied by free mobility of labor across the continent.<sup>25</sup> These public adjustment costs also could be compounded by shifting capital across sectors, particularly if structural transformations are lengthy and lead to shrinking fiscal space in a context of a transitory growth deceleration.

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<sup>24</sup> Trading under the AfCFTA was due to commence on July 1, 2020, but was postponed to January 1, 2021 as a result of the COVID-19 pandemic.

<sup>25</sup> These costs are already significant, and they could become prohibitively high, in a region where unemployment rates have been at Great Depression levels for decades.

That being said, most studies assessing the fiscal impact of AfCFTA-related reforms show that Africa-wide average tariff revenue losses would be limited (IMF, 2019) because customs revenues mirror the level of intra-regional trade, which remains relatively low and heavily skewed—South Africa alone accounted for more than 23 percent of total intra-African trade in 2019, and SADC accounted for more than 60 percent. Despite a relative increase in intra-African trade—which rose from 9.8 percent of total African trade to around 14.4 percent during the two decades ending in 2019—only a small fraction of aggregate customs revenues depends on regional cross-border trade (Afreximbank, 2020). Moreover, cross-border trade within prevailing African economic communities is either carried out on a tariff-free basis or via relatively low tariffs applied on imports.

Overall, the weighted average of customs revenues from cross-border trade flows across the region during the five years ending in 2017 (in the run-up to the official launch of the Tripartite Free Trade Area) was 0.20 percent of GDP, against 1.9 percent of GDP for levies from total African trade. Moreover, the continental averages of intra-African trade revenues could mask sizable differences in a region where countries are at dissimilar stages of economic development and in the process of structural transformation, reflected in the variance of sources of growth and of openness to trade.<sup>26</sup>

While the AfCFTA, with 55 member countries, not only has the largest membership of a free trade area since the launch of the General Agreement on Tariffs and Trade (the forerunner of the World Trade Organization) 70 years ago, but is also the most diverse, with countries that are both resource-rich and resource-poor, coastal and landlocked, and that have high and low population density. Furthermore, the continent includes diversified and complex economies, such as South Africa and Egypt, which are increasingly globally competitive in the product sophistication space.

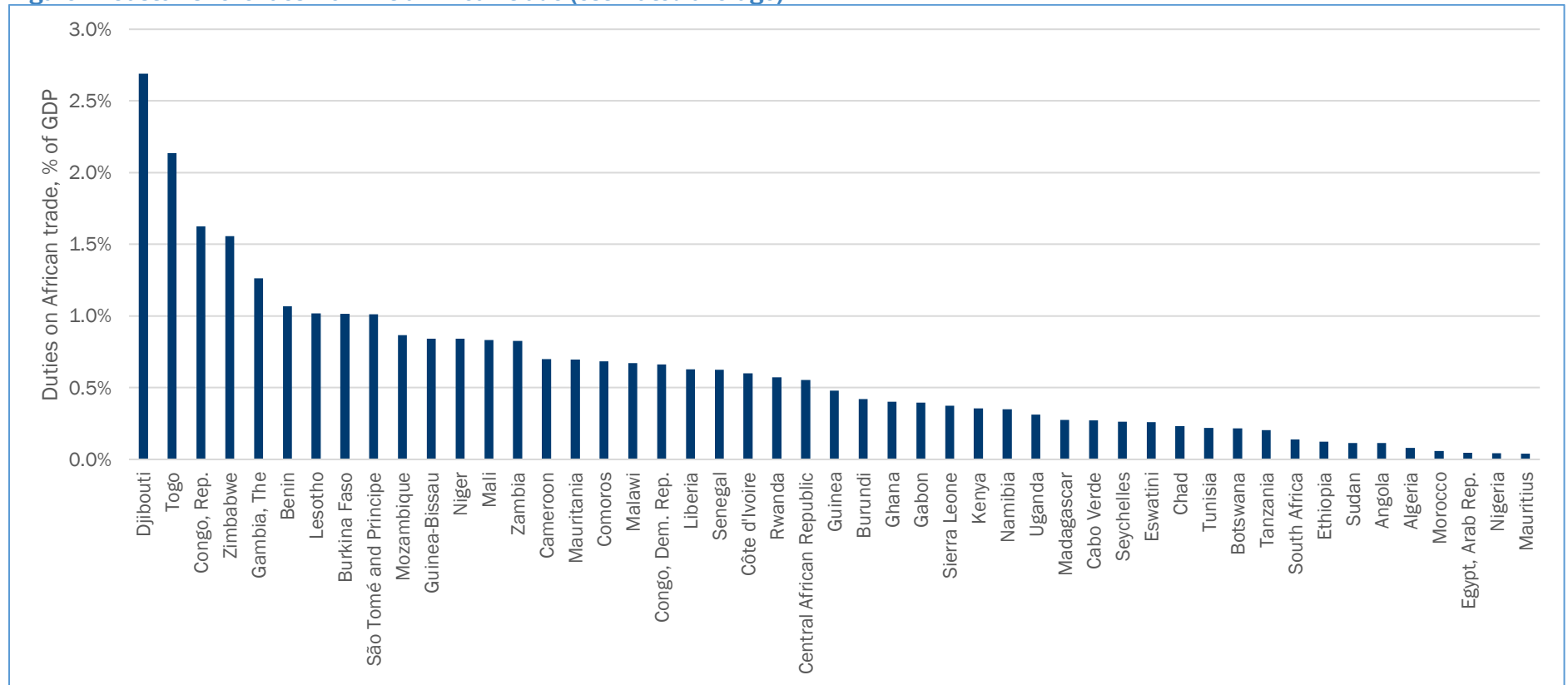
These differences have been reflected in the asymmetric nature of shocks confronting countries across the region. For instance, the sharp drop in oil prices following the end of the commodity super-cycle in the second half of 2014 exacerbated the liquidity constraints and macroeconomic management challenges in African countries where oil accounted for a sizable share of fiscal revenues and foreign exchange earnings. Then again, the price drop was a boon for net oil-importing and resource-intensive economies. These differences could further magnify the challenges of strengthening the commitment of all member countries for a uniform convergence during implementation of the AfCFTA.

The deepening process of trade integration and the elimination of tariffs will affect these countries differently. Analytically, the countries that are most vulnerable to fiscal adjustment shocks also are the ones with high intra-regional trade intensity. While the weighted averages of customs revenues from cross-border trade, expressed as a percentage of GDP, were relatively low for most countries in the region during the five years ending in 2017, they exceeded 1 percent of GDP in a few countries (Figure 4). Some of these highly vulnerable countries are the leading drivers of intra-African trade, with the cross-border component of their aggregate imports mostly higher than the average for the region. These nations are likely to suffer disproportionately large revenue losses following the elimination of tariffs on 90 percent of currently taxed intra-regional trade flows, during the implementation of the AfCFTA. Therefore, the AfCFTA could be a mixed blessing for some members in the early phases of implementation.

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<sup>26</sup> Most recent estimates and analyses of the degree of trade openness across the region show a large variance, ranging from 21 percent of GDP in Tanzania to 126 percent of GDP in the Republic of Congo.

Figure 4: Customs revenues from intra-African trade (estimated average)



Source: World Development Indicators (World Bank) and Harvard Atlas of Economic Complexity.



In the medium and long term, the AfCFTA will raise the GDP of member countries and broaden their tax bases through several channels, including trade creation, dynamic comparative advantage, and international product cycle. However, the short-term fiscal adjustment costs could be significant, especially for countries that source a large portion of their imports within the region or have limited fiscal space and could face widening fiscal deficits. The sudden large fiscal revenue declines could widen these deficits and undermine macroeconomic stability and debt sustainability. More generally, they could compromise the reform dividends associated with the implementation of the AfCFTA if short-term mitigation measures are not undertaken.

These early champions of intra-African trade should not be penalized during the implementation of continental trade-integration reform. However, exposing them to significant short-term revenue losses could result in the most vulnerable countries resorting to trade diversion. Such a situation could weaken the continental trade reform and hinder its ability to encourage more investors to take advantage of expanding economies of scale and improved competitiveness to spread the risk of entering smaller African markets and inject patient capital to accelerate industrialization processes.

Reaping the benefits of economies of scale requires a large membership and a commitment to deepening the process of trade integration over time. The benefits of trade integration are proportional to the size of membership in any given trade bloc: Implementing policies that will effectively mitigate the short-term fiscal adjustment costs that vulnerable countries face is critical to breaking the curse of small markets and remaining on a win-win track throughout the implementation of the AfCFTA.

The governments of the few countries most exposed to short-term revenue losses should prioritize the implementation of policies that improve their fiscal positions through better tax compliance and enforcement. Such policies should include strengthening value-added tax (VAT) systems, streamlining exemptions, and expanding the coverage of income tax. The policies should also diversify the sources of growth, broaden the tax base, develop new sources of taxation, and harness technologies to improve record-keeping, monitoring, and auditing. The latter is particularly important in a region where multinational companies have used a complex web of international tax laws and a wide range of accounting techniques, including accelerated depreciation and offshore tax sheltering, to skirt paying taxes (IMF, 2018).<sup>27</sup>

However, these fiscal reforms are unlikely to mitigate entirely the short-term adjustment costs associated with sudden large revenue losses. A recent review of domestic resource mobilization efforts across Africa revealed disappointing results: Despite sustained efforts over the last two decades, Africa remains the region with the lowest revenue-to-GDP ratio in the world (IMF, 2018). Inevitably, there will be challenges in identifying short-term alternatives to sudden large revenue losses after the elimination of tariffs on 97 percent of existing intra-regional trade flows, the most ambitious target under the AfCFTA.

One temporary solution for countries that have high elasticity of intra-African trade flows to tariffs and limited room for fiscal revenue expansion is to tap the AfCFTA Adjustment Facility. This instrument provides short- to medium-term financing to vulnerable countries, enabling them to adjust smoothly to sudden tariff revenues losses and macroeconomic management challenges arising from the implementation of the AfCFTA. The African Export-Import Bank (Afreximbank) unveiled the facility

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<sup>27</sup> Multinational corporations operating in Africa have engaged in a wide range of accounting mechanisms and tax evasion schemes, including accelerated depreciation and profit shifting, also known as offshore tax sheltering. Furthermore, illicit financial flows cost Africa more than \$50 billion every year, according to conservative estimates (UNECA 2016).

during the official launch of the operational phase of the AfCFTA by African Heads of State and Governments.

The long-term solution to fiscal and debt sustainability is the diversification of sources of growth and trade through the development of regional value chains and transition from resources-dependent economies to more diversified and knowledge-based economies, with increasing industrial output and manufactured goods. A preliminary assessment of the potential growth and development impact of the AfCFTA shows that the most diversified economies would benefit the most in the short term, partly because industrial products and manufactured goods account for the lion's share of intra-African trade (Saygili et al. (2018), IMF (2019)). These goods are less affected by commodity price cycles and have been the major drivers of trade and per capita income growth in other parts of the world. Measures to support long-term solutions would include medium- to long-term financing for diversifying exports and for developing vertically integrated industries to propel the growth of regional value chains and their integration into global value chains.

Signing the AfCFTA agreement was a political act with no immediate fiscal implications for signatories. Doing so has galvanized the continent and strengthened the foundation for the trade integration framework articulated decades ago by the Organization of African Unity. However, effectively implementing the continental free trade agreement could entail huge costs, especially short-term fiscal adjustment costs, for the most vulnerable countries. These costs could transform the initial win-win continental trade-integration project into a win-loss trade-integration outcome, if sudden tariff revenue losses and other adjustment costs become a source of persistent macroeconomic instability

Thus, negative fallout from short-term costs is one of the major downside risks facing Africa in the early phases of the AfCFTA implementation. Any short-term asymmetric distribution of benefits arising from the continental trade-integration reform could weaken the broad-based support needed to reap the tremendous potential associated with increasing economies of scale and efficiency gains during its implementation (Fofack 2018b). Mitigating these short-term fiscal adjustment costs at the outset is key to successfully actualizing the AfCFTA and should be a priority for all stakeholders, potential winners and losers alike.

## **6. Strengthening the security and development nexus for AfCFTA implementation**

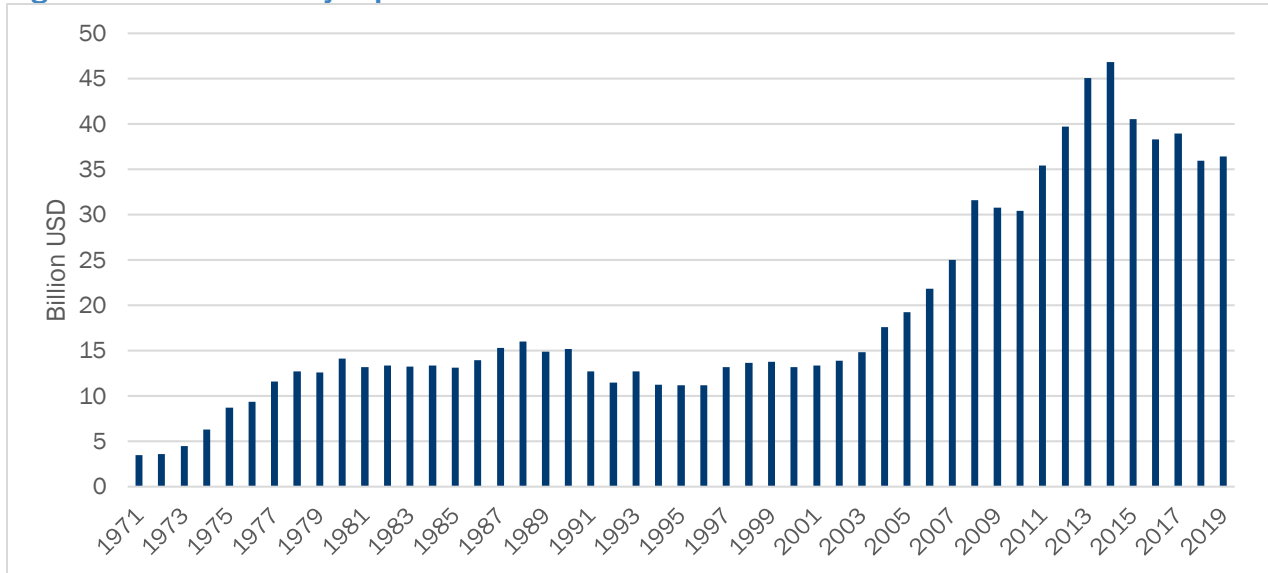
“No state can stand wholly alone in today's world. We all share responsibility for each other's development and security. Collective strategies, collective institutions and collective actions are indispensable,” said then-Secretary-General Kofi Annan in his 2005 report to the United Nations General Assembly. But, as Africa takes the next critical step in implementing the AfCFTA, with trading under the agreement scheduled to start on January 1, 2021, the security issue looms large.

For a long time, Africa has consistently been the most conflict-prone part of the world. According to the World Bank, 21 African countries are contending with high institutional and social fragility (9) or are in a state of either medium- (10) or high-intensity conflict (2). The last few years have been the most particularly bad in terms of fatalities, with the number of conflict deaths averaging 14,000 per year since 2014, versus 2,200 annually in 2010 (IMF (2019), Fofack (2021)).

The acceleration of high-intensity conflicts—increasingly driven by both intrastate and transnational actors in a context of expanding terrorist networks—has resulted in the dramatic increase of countries' military expenditures—more than threefold since the beginning of the century. In 2014, African

defense spending set a one-year record of \$45 billion, in a region where large financing gaps have constrained infrastructure development programs intended to propel economic growth and cross-border trade (Figure 5).

**Figure 5: Trend of military expenditures in Africa**



Source: World Development Indicators, World Bank.

Over the last several years, the securitization of the development discourse has led to a subordination of development concerns to security issues, especially in conflict-afflicted countries. While that swing may be explained by the frequency of high-intensity conflicts, the relationship between security and development is complex and driven in large part by a non-linear and co-dependent structure. Long, drawn-out development can stir up grievances, and conflict can threaten development, destroying economic and physical infrastructure, raising the costs of doing business, and fragmenting markets.

From this fact arises the need to foster both aspirations simultaneously. Mutually-reinforcing defense and development initiatives could beget a virtuous cycle of peace and prosperity, sustained by the proper allocation of scarce resources towards the type of productive investments needed to crowd-in private capital and address supply-side constraints. Alleviating these restrictions will bolster intra-African trade, which, even by developing-region standards, remains dismally low.

Historically, the consequences and socioeconomic costs of insecurity have been a major challenge to growth and integration. These could re-emerge as acute downside risks in the pursuit of a more stable security and development nexus during the AfCFTA's implementation. Rebalancing the scales of Africa's security and development nexus to optimize the allocation of scarce resources will be vital in addressing the region's large trade and infrastructure financing gap. Filling that gap will raise productivity, expand industrial output, and reduce dependency on imports of manufactured goods. The latter in particular has been a major driver of structural current account deficits, especially when combined with long-term deterioration of commodity terms of trade.

These development challenges, magnified by the pandemic (as countries the world over imposed export restrictions to bolster their domestic supplies, it became more difficult for African nations to

confront the intertwined health, economic and social effects of COVID-19<sup>28</sup>), underscore the significance of long-term security for sustainable development. Security is the parameter that will place and sustain Africa on an irreversible, long-run growth trajectory. Moreover, it is the vector that will incentivize the injection of patient capital, which will kindle the diversification of sources of growth and continuously boost cross-border trade and investment throughout the AfCFTA's implementation. It follows that deepening the process of economic integration is likely to expand growth opportunities, reducing the risk of conflicts.

Successfully implementing the AfCFTA and deepening economic integration—through such bodies as a customs union, common market, economic union, and political union—hinges on creating the right conditions for long-term security. Only lasting peace will guarantee lasting prosperity. In Africa, the interdependence between security and development is such that they are not only mutually reinforcing goals; they should become desirable policy objectives for sustainable development during the AfCFTA's implementation.

While ongoing efforts to deepen economic integration under the agreement have the potential to transform Africa's economy and flatten the income inequality curve, realizing this potential depends largely on delivering peace and security in the short term and sustaining that environment over time. Policies geared towards intertemporal security objectives that have intergenerational consequences, particularly in respect to regional integration and development, should aim to strengthen national and continental judicial institutions and ensure accountability in line with collective responsibility to the principle of non-indifference. Policymakers must adopt a bold agenda of conflict prevention by improving governance, reforming the security sector, and strengthening the rule of law in all AfCFTA member countries.

Countries should prioritize reforms that promote robust economic and democratic governance with a view to fostering inclusive participation, transparency, accountability, equity and respect for judicial institutions. Over decades, deficits in these critical areas have emerged as some of the main causes of conflict. Beyond undermining economic performance, the subordination of development aspirations to short-term security considerations breeds corruption (Alfada (2019)). By lowering investment and government revenues through tax evasion, and by distorting government expenditures and exacerbating income inequality, corruption undercuts both security and development.

After the first round of economic research that shed light on the insidious effects of corruption on growth—including, among other things, lower quality of infrastructure and public services, distortion in the composition of government expenditures, adverse budgetary consequences, loss of tax revenue and reduced aid effectiveness—the second generation, controlling for policy environments, produced even more insightful results.<sup>29</sup> Unequivocally, and while corruption is bad for growth in general, its economic costs are on average significantly more severe in conflict-afflicted countries.

These findings are supported by a growing body of empirical studies into the potential impact and channels through which corruption may destabilize growth (d'Agostino et al. (2016), Novta and Pugacheva (2020)). In one of the most comprehensive and definitive studies, Giorgio d'Agostino found that the indirect effects of corruption, through consumption and military expenditures, have a strong

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28 However, even before the COVID-19 pandemic, the outbreak of the Ebola virus and armed conflicts that have consistently distorted the allocation of public expenditures, undercut investment, and triggered border closures within the region have been among the major constraints to the diversification of sources of growth needed to boost cross-border trade and drive economic integration.

29 For more details see Shleifer, A., and R.W. Vishny (1993), Mauro (1997), and Treisman, D. (2000).

negative impact on growth, suggesting that its growth-deteriorating effects are even more important during conflicts.

If reforms promoting steadfast economic and democratic governance are complemented by similar improvements to the judicial system and security sector, emphasizing accountability and the protection of citizens, then the dividends in terms of conflict prevention will be even more important. In addition to strengthening the foundation of peace and security across Africa, the combined effect of these reforms will encourage a departure from repressive traditions and deliver a safe and stable environment for political inclusion and economic growth.

With a few exceptions, progress in reforming security forces across the region, following a more inclusive and citizen-centric approach, has been promising. A growing number of African countries are settling political differences through the rule of law, rather than down the barrel of a gun. In some cases, judiciaries have been greatly empowered and are increasingly exercising their independence from the inertia of political forces: One noteworthy example is the decision of the constitutional court of Malawi to annul the result of the 2019 presidential election in light of substantial poll irregularities; the rerun in the summer of 2020 resulted in a victory for the opposition.

Governance reforms are also likely to have positive spillover effects for institutional stability and regional integration in the long run, and so should be sustained and broadened across the continent. In particular, greater institutional stability and predictability will curtail the risk of discontinuity in the commitment to regional integration during political and democratic transitions.

Integration is a long-term process, and sustaining political commitment to the ideal of regional and continental integration during political transitions will be key to its success. This is doubly true in Africa, where countries are at markedly different stages of development and will suffer varying fiscal adjustment costs after the elimination of tariffs on existing intraregional traded goods (IMF (2019), Fofack (2021)).<sup>30</sup>

Although integration is, at its core, a political project, achieving success in this venture is contingent on recognizing that the project is too important to be politicized. In other words, the commitment to deepening the process of economic integration under the AfCFTA should not be affected either by political barometers or business cycles. Instead, the security and development nexus must be consistently strengthened to optimize the allocation of scarce resources in support of growth and to mitigate the risk of backtracking on integration.

The stability of Africa's security and development nexus, and its implications for long-run growth, depends also on conflict prevention. Although the drivers of intrastate conflicts are complex and multidimensional—encompassing, among other factors, social inequality, state failure, human rights violations, and resource predation—they fall mostly within the socioeconomic sphere. In this regard, national development strategies that address deteriorating economic and social conditions, promote good governance and preserve the environment will not only thwart conflicts, but also keep countries on a sustainable economic growth path.

While conflict prevention would be the optimal scenario in the AfCFTA's implementation, clashes cannot be ruled out. After all, the negotiations leading to the agreement's ratification were carried out

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30 The AfCFTA will eventually liberalize at least 97 percent of tariff lines and 90 percent of imports by the end of its implementation period.

against a backdrop of increasingly frequent high-intensity conflicts. In this respect, effective short-term policies should combine both conflict prevention and management.

Success in conflict management requires key parties to consider the political ecology of security and development, which is highly context-specific. While engaging all interested parties involved in the process is critical for peacebuilding, it is important also to recognize that the security and development nexus is neither stable over time nor consistent across countries. Identifying the problem and tailoring assistance to address it will require even better coordination among key actors.

In a globalized world characterized by increasing interdependency, the stability of the security and development nexus depends also on the nature of engagement with international development partners. These institutions have, over the years, played an outsized role in the process of economic development and conflict management across Africa.

Despite the significant part played by the international community in conflict management and post-conflict reconstruction in Africa, a review of donor support and interventions in conflict-afflicted countries reveals that it is extremely difficult to trace funding within countries, across sectors, and especially across governments (Tschirgi (2018, 2019)).

Policymakers increasingly recognize the enlargement of the 'spider web' of donor funding as a major handicap in conflict management. On several occasions, this web has been found to be largely responsible for causing conflicts to persist and lowering the probability of truces being struck. Empowering governments and actors in conflict-afflicted countries and making international support more constructive remains a challenge, but it is an obstacle that must be overcome before Africa can in earnest achieve peace and prosperity. Acknowledging the extent of these challenges, as well as the potential returns associated with the implementation of the right reforms and improved international coordination, the U.N. and African Union, among other organizations, have called for an integrated security and development policy for effective conflict prevention and management.

Another area where effective donor coordination will enhance conflict prevention concerns the illicit inflow into and proliferation of weapons in Africa. Tens of millions of firearms, most of which are not manufactured locally, are in circulation in the region (AU (2019)).<sup>31</sup> It is crucial that policymakers the world over take steps to reform the geopolitical architecture of global security to ensure greater transparency and accountability. The African Union, for its part, has developed its own roadmap of "Practical Steps to Silence the Guns in Africa by Year 2020," which provides a framework for collective and coordinated actions to deal with illicit weapons inflows onto the continent as trading under the AfCFTA begins.

Rebalancing the scales of Africa's security and development nexus is a daunting task, but it is one that the region's leaders must seize with both hands. To quote again the late, great Kofi Annan, "There will be no development without security, and no security without development and both depend on respect for human rights and the rule of law."

## 7. Conclusion

It is fair to tout the AfCFTA as an economic and globalization game changer. The world's largest free trade area in more than 70 years aims to defragment Africa and transcend the colonial boundaries

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31 For more details, see <https://reliefweb.int/sites/reliefweb.int/files/resources/SAS-AU-Weapons-Compass.pdf>.

erected during the Berlin Conference in the 19th century. Economies of scale and competitiveness gains associated with the reform could accelerate the process of industrialization in Africa and the diversification of its sources of growth, which could lift its living standards closer to those in high-income countries. The AfCFTA is also expected to boost both extra- and intra-African trade. Most empirical models suggest that these increases would be mutually reinforcing, since manufactured goods account for the lion's share of intra-African trade.

Preliminary estimates say that the other significant potential gains of the reform will be the strengthening of Africa's bargaining power in international trade negotiations, the sustainable increase in its share of global trade, and the catalyzing of the growth of regional value chains and their integration into global value chains. Such gains would enhance the continent's integration into the global economy, where trade largely has been dominated by manufactured goods with increasing technological content.

However, there are several challenges associated with ongoing efforts to deepen economic integration through the elimination of tariffs and the progressive liberalization of trade: an infrastructure deficit, securitization of development, fiscal adjustment costs, supply-side constraints, financing of African trade and development, and the stickiness of nontariff barriers that could reduce the overall gains. These challenges will become even more apparent during the implementation phase of the AfCFTA. Until now, the emphasis has been on the potential costs of nontariff barriers, as well as logistical and infrastructure constraints.

This paper stresses the need to raise sufficient resources to finance African development, tackle supply-side constraints, invariably strengthen the security and development nexus to optimize the allocation of scarce resources in support of growth and diversification of exports, and accelerate the economic transformation of the AfCFTA member economies. It also emphasizes the risks posed by short-term fiscal adjustment costs, namely, sudden revenue losses for a few countries because of the elimination of tariffs on cross-border trade flows. If the most vulnerable countries opt for trade diversion to mitigate these losses, this could weaken the trade reform.

This paper outlines a set of policy options to mitigate these risks and ensure that the trade-integration process steers the region toward the final stage of economic integration—complete monetary union and harmonization of fiscal policy. It articulates policy reforms to address supply-side constraints, with the goal of ensuring that the rules of origin that form the core of the AfCFTA function as an accelerator for industrialization and not as a constraint to growth and export diversification. The paper also outlines policies for mitigating the risk of sudden large revenue losses following the elimination of tariffs on intra-African traded goods. It stresses the need to revive national development banks to grow the scale of patient capital and to drive diversification of exports while at the same time, mitigating the risk of maturity mismatch that has deterred investors and that could heighten the supply-side constraints during implementation of the AfCFTA. Finally, it stresses implementation of policies fostering peace and security to keep the region on an irreversible path of long-run growth and deepening process of integration.

Prospects for successfully implementing the AfCFTA would be greater if concerted efforts were made at the continental level to ensure that the reform significantly raises Africa's share of global trade, which remains dismally low and could undermine the process of wealth accumulation and convergence with global incomes. It will be particularly important to expand Africa-South trade, which has been the main driver of African trade and growth in the last decade. The development and expansion of South-South trade and investment is affording firms more opportunities to access frontier

technology. It is enabling firms in the South to move up in global value chains, and in the process, increase their bargaining power and competitiveness. Increasing South-South trade will be critical for accelerating the development of regional value chains in Africa and for connecting them to global value chains.

Progress toward defragmenting Africa's economies and deepening the continent's economic integration is already palpable. However, the AfCFTA was launched in an increasingly challenging zero-sum-game, beggar-thy-neighbor global economic and trade environment. Pan-African solidarity among the continent's diverse countries will be necessary to strengthen the region's bargaining power in international trade negotiations and to grow its share of global trade. However, the diversity of the pact's member countries and their competing economic interests make it difficult for them to consistently speak with one voice in external engagements.<sup>32</sup> This is perhaps the most salient risk facing the region in its engagement with external partners during the implementation of the AfCFTA.

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<sup>32</sup> In addition to pan-African solidarity among the continent's diverse countries, two other objectives underpin Agenda 2063: 1) establishment of a large membership to break the curse of small markets, and 2) deeper integration to reap all the benefits of integration. Together, these three complementary objectives underpin the new framework for Africa's engagement with the rest of the world.



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