# OPPORTUNITIES FOR VIETNAM’S AUTOMOTIVE SECTOR UNDER THE TPP

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# OPPORTUNITIES FOR VIETNAM'S AUTOMOTIVE SECTOR UNDER THE TPP

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ABSTRACT

The Trans-Pacific Partnership, the world's largest free trade agreement covering 40% of global GDP and nearly one third of global trade, was agreed in February 2016. It is likely to lead to the consolidation and restructuring of manufacturing global supply chains, in particular affecting the textile and automotive sectors.

Specifically, the TPP provisions on tariff reductions and regional value content requirements on vehicles and auto parts, could be a driving force for automotive manufacturers in restructuring their supply chain model, providing significant opportunities to integrate into global value chains.

On October 5 2015, after more than five years of negotiations, the countries participating in the Trans-Pacific Partnership (TPP) Agreement agreed on a final outcome and officially declared the conclusion of the negotiations. On February 4 2016, all TPP members gathered in Auckland, New Zealand to sign the agreement. By participating in the agreement, its members expect to create a new regional economic cooperation model, which will promote trade and investment in the region, handle a large number of recent issues in the international trade arena, and become an entry point for the future Asia-Pacific free trade area.[2] If the agreement is ratified,[3] the TPP would create the world's largest free trade area, covering 40% of global GDP and nearly one third of global trade.

The agreement will also lead to the restructuring of global supply chains in the manufacturing industry. It will especially affect the textile and apparel, and the automotive sectors, which are two significant sectors for TPP members, providing deeper integration opportunities in global value chains. Vietnam is the largest apparel exporter among the TPP members, and is therefore one of the most benefitted by the agreement. Nevertheless, the opportunities for the automotive sector are still not clear.

This article focuses on identifying opportunities for the automotive sector producers, by reviewing the TPP-specific provisions affecting this sector, analysing the auto-related trade flows amongst the TPP members, and highlighting Vietnam's potential to become a regional automotive manufacturing hub.

## AUTOMOTIVE RELATED PROVISIONS OF THE TPP

The TPP contains specific provisions affecting the automotive industry that may lead to a significant change to the sector's supply chains, particularly the provisions on tariff elimination

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[2] A free trade area of the Asia-Pacific region (FTAAP) is an APEC initiative, firstly mentioned in the Bogor Declaration of 1994, where the APEC economies committed themselves to the achievement of free trade and investment in the Asia-Pacific region.

[3] The TPP is now undergoing a two-year ratification period, in which at least six countries - that account for 85% of the combined gross domestic production of the 12 TPP nations - must approve the final text for the deal to be implemented. There are twelve TPP members, including Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the USA, and Vietnam.

(Chapter 2 and its Annexes), and on rules of origin (RoO) (Chapter 3 and its Annex and Appendix). Many members still impose high tariffs on vehicles, and their elimination would have a large impact on trade flows and production systems. Vietnam is one of the TPP countries maintaining the highest tariff on imported vehicles, with an average tariff above 40%, and a maximum level of 70%.

Under the TPP, in order to benefit from preferential market access, vehicles and auto parts must satisfy the regional value content (RVC) requirements. Under the provisions related to product-specific rules of origin (PSRoOs), as regulated in Annex 3-D of Chapter 3, vehicles will be considered *originating* provided that the goods have a RVC of not less than 45% under the net cost method, or 55% under the build-down method. Auto parts will qualify for preferential treatment if they meet the requirements on either tariff change, or RVC from 35% to 55%, depending on parts and the methods applied.

In addition, as mentioned in TPP's Appendix 1 to Annex 3-D, for the purpose of satisfying the vehicle's RVC requirements, seven specific auto parts listed in Table A[4] used in the production of the vehicles may be considered originating if they either satisfy their own RVC requirements, or go through at least one of eleven operations within the region, as specified in Table B[5]. Furthermore, regarding key auto components, such as engines, gear boxes, and steering wheels, specified in Table C, for the purpose of satisfying their RVC requirements, materials and parts used in the production of these components are considered originating if they either meet their own RVC requirements, or undergo at least one of the operations listed in Table B. However, the value of the materials that are originating under the latter condition shall be counted as originating content, provided that the value counted as originating content does not exceed the applicable threshold of 5% or 10% of the value, as indicated in Table C (Build-up Method/ Build-down Method) or net cost (Net Cost Method) of the good.

The TPP provisions on tariff reductions and RVC requirements on vehicles and auto parts could be a driving force for automotive manufacturers in restructuring their supply chain model, providing members, where the automotive industry has not yet matured, as is the case in Vietnam, greater chances to integrate into global value chains by focusing on Table B operations, and special materials and parts listed in Tables A and C.

## AUTOMOTIVE TRADING IN THE TPP

Amongst the TPP members, trade in automotive products accounts for 10% and 8.7%, respectively of the export and import of the TPP region with the world. Most of the automotive products are traded internally, with a share of more than 60% of the region's automotive trading value with the world. Passenger cars and auto parts are major trading products, with their total trading value accounting for nearly 80% of the automotive trading value of the TPP region with the world. Amongst the different TPP members, there are five dominant players, namely the USA, Canada,

[4] These seven parts are: Toughened (tempered) safety glass; Laminated safety glass; Bodies (including cabs), for the motor vehicles of heading 87.03; Bodies (including cabs), for the motor vehicles of heading 87.01, 87.02, 87.04 and 87.05; Bumpers (not including parts thereof); Body stampings and door assemblies (not including parts thereof); and Drive-axles with differential, whether or not provided with other transmission components, and non-driving axles (not including parts thereof).

[5] Those processes are: complex assembly, complex welding, die or other casting, extrusion, forging, heat treatment, laminating, machining, metal forming, moulding, and stamping.

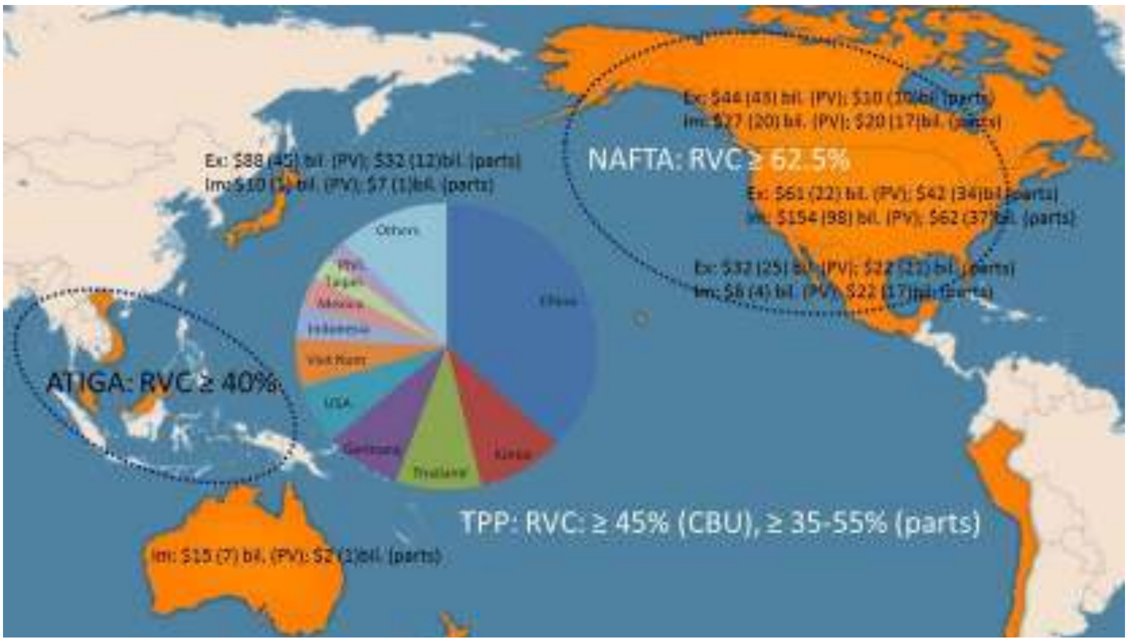
Mexico, Japan and Australia. The North America Free Trade Agreement (NAFTA) is the catalyst for the dynamic automotive trading across the USA, Canada, and Mexico.

The TPP region overlaps with two other free trade areas, i.e. NAFTA and the Association of South East Asian Nations (ASEAN), the two most dynamic automotive trading and manufacturing regions in the world. While all NAFTA members are included in the TPP, only four of the ten ASEAN members are parties to the TPP, namely Brunei Darussalam, Malaysia, Singapore, and Vietnam. Amongst them, only Malaysia and Vietnam have an automotive industry, providing them a great advantage over the three other ASEAN automotive manufacturing countries, i.e. Thailand, Indonesia, and the Philippines, which are non-TPP members. These three countries have recently expressed their interest in joining the agreement, meaning that Malaysia and Vietnam should make good use of their advantage before it will be neutralised by the participation of their neighbouring competitors in the agreement.

Each free trade area has specific provisions on RVC requirements. The NAFTA RoO for automotive products are based on a tariff change alone, or a tariff change and a RVC requirement, with the RVC for these products calculated using the net cost method. The RVC requirement for autos and light vehicles, and their engines and transmissions, is 62.5%; and for other vehicles (e.g. tractors, vehicles for the transport of 16 or more persons, trucks), and their engines and transmissions, as well as other auto parts, is 60%. In ASEAN, to be considered originating, automotive products must meet the RVC requirement of not less than 40% of value-added or change in tariff heading (CTH).

The differences in RVC requirements and calculating methods between regions, provide greater flexibility for the automotive manufacturers in qualifying their products. With a higher requirement on RVC percentages and the same calculating method, NAFTA countries have an advantage over the non-NAFTA countries in satisfying RVC requirements. In other words, the TPP members in Asia, Australia, and Latin America have a larger space to take advantage of the TPP, to better integrate into the automotive global value chain. Notably, among the major automotive traders, Japan is a non-NAFTA country, and automotive trading between Japan and other TPP

**Figure 1**. Automotive trading of the TPP's dominant players, 2014




Source: ITC Trademap.

Notes: Each country's trade value with the world and the TPP (in brackets) are expressed on its map; Ex = Export, Im = Import, PV = Passenger vehicle. The pie chart shows Japan's auto part import sources.

partners is still modest. The current biggest automotive trading partners with Japan are China, Korea, and Thailand, which are non-TPP members. It is crucial for Japan to take a leading role in collaborating with other TPP members, to utilise the agreement for restructuring the automotive supply chain model, and among them, Malaysia and Vietnam are two potential candidates.

The development of the automotive industry varies in each member state; thus each one will experience different impacts from the agreement. A study by the Peterson Institute for International Economics (2016) concludes, that while the TPP contributes to the liberalisation of the auto sector in many TPP member states, particularly Vietnam and Malaysia, for large auto and auto parts producers (particularly the United States, Mexico, and Canada) the agreement is focused on protecting the domestic industry through RVC requirements and long tariff expiration periods.[6] Another study by Head (2015) predicts that the TPP will affect "*many margins of adjustment, shifting the distribution of where cars are assembled, offered and sold, both inside and outside of the TPP*."[7] Its estimations reveal that major car-producing members will reduce output for their home market. However, Japan overall, will expand production by 12.4% owing to an increase in car sales to the other TPP members, while the US industry will contract by 9.3%. The study concludes that the TPP will bring considerable disruption to the industry, while offering sizeable gains for car buyers.[8] PwC (2015) indicates that the TPP's automotive RoO provide automotive manufacturers greater flexibility in qualifying their products, providing access to markets, and enhancing their competitive position. The impact of these new rules on automotive industry companies will add complexity to an already complex set of rules from the various free trade agreements (FTAs) already in place.[9]

## POTENTIALS FOR VIETNAM TO BECOME AN AUTOMOTIVE MANUFACTURING HUB

Following the success of acceding to the WTO in 2007, Vietnam has maintained its global integration policy by signing FTAs with a number of trading partners. By joining the TPP, and concluding negotiations of a FTA with the EU (EVFTA) and a Customs Union with Russia, Belarus, and Kazakhstan (VCUFTA), Vietnam has become a potential gateway to access more than 70% of world automotive imports without tariff barriers.

Vietnam currently has the smallest automotive market among five ASEAN auto manufacturing countries, headed by Thailand. Vietnam's automotive industry will face fierce competition from other ASEAN partners, especially Thailand and Indonesia after 2018, when tariffs on ASEAN originated vehicles are fully phased out. However, the TPP presents new opportunities to Vietnam's automotive industry. Without the TPP, Vietnam's automotive industry can only lean on scattered and small local markets. The TPP could transform Vietnam into ASEAN's second largest automotive manufacturing hub after Thailand, and instead of depending on its small local market, the industry could develop into a new driving force, derived from export-oriented auto part manufacturing development. This new approach could absorb significant new auto manufacturing

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[6] See Petri, P. A. and Plummer, M. G. (2016), The Economic Effects of the Trans-Pacific Partnership: New Estimates, Peterson Institute for International Economics, Working Paper Series 16-2, January.
[7] Head, K. (2015). How will the TPP affect the auto industry?, World Economic Forum. Available at: https://www.weforum.org/agenda/2015/11/how-will-the-tpp-affect-the-auto-industry/
[8] See *Ib*.
[9] See PwC (2015). What will the Trans-Pacific Partnership mean to the Automotive Industry? Customs & International Trade, December 7.

investment, as Vietnam will become a more attractive location from which to source auto parts and components.

Nevertheless, these potentials cannot automatically transform Vietnam into the automotive manufacturing hub if no supportive policies are taken to realise them. Automotive provisions and trading patterns of the TPP suggest that in order to strengthen Vietnam's automotive industry, the country should have a more strategic and selective FDI attraction policy to bring auto part manufacturers from key partners into Vietnam, and this policy must run in parallel with capacity building for local enterprises, with a focus on the special parts and operations mentioned in Annex 3-D's Tables A, B and C.

For automotive manufacturers, the TPP and other FTAs will have significant impacts on their supply chain model and operations. The TPP's provisions on tariff elimination, particularly auto parts, RVC requirements, and tariff expiration periods, as well as the interference between the TPP and other FTAs, particularly NAFTA, ATIGA, and later RCEP, require them to enhance their FTA compliance, restructure their procurement sources, and relocate their production bases to utilise FTAs most effectively.

## ABBREAVIATIONS

| | |
|---|---|
| **APEC** | Asia-Pacific Economic Cooperation |
| **ASEAN** | Association of Southeast Asian Nations |
| **ATIGA** | ASEAN Trade in Goods Agreement |
| **CTH** | Change in Tariff Heading |
| **EU** | European Union |
| **EVFTA** | EU-Vietnam Free Trade Agreement |
| **FDI** | Foreign Direct Investment |
| **FTA** | Free Trade Agreement |
| **FTAAP** | Free Trade Area of the Asia-Pacific |
| **GDP** | Gross Domestic Product |
| **NAFTA** | North-America Free Trade Agreement |
| **PSRoO** | Product-Specific Rules of Origin |
| **RCEP** | Regional Comprehensive Economic Partnership |
| **RoO** | Rules of Origin |
| **RVC** | Regional Value Content |
| **TPP** | Trans-Pacific Partnership |
| **VCUFTA** | Vietnam-Customs Union Free Trade Agreement |

# HOW CAN WE HELP?

## Support C-level executives and boards to prepare for different challenges

*International Economics* can help facilitate internal discussions on strategy by providing technical insights, developing dashboards of key performance measurements, and giving advice to executive boards on building resilience to possible disruptions related to exogenous trade shocks, such as Brexit or Donald Trump's Presidency. We work closely with our clients to brainstorm and identify challenges and opportunities based on our professional experience.

## Map market access

In order to quantify the potential costs to your business in engaging in trade, including tariffs, standards, and customs procedures, among many others, we (i) undertake a mapping of which terms are most at risk of changing and by how much, depending on the type of agreements; and (ii) quantify and forecast the potential effect on your business using predictive analytics to generate insights into future outcomes.

## Navigate through trade and investment agreements

With more than 400 trade agreements and 2,400 investment agreements already in place, *International Economics'* team is able to navigate through them, guiding and identifying which specific agreement will better suit the interests of our client. Additionally, we have developed optimization techniques, through the use of sophisticated rules and algorithms, to analyse the Free Trade Agreements (FTAs), which are growing in space, depth and complexity, in order to offer insights into investment and trade decisions. With increasing fragmentation of global production networks and the need for careful evaluation of supply chain risks, the tools developed by *International Economics* offer a solid foundation for the adoption of critical decisions by businesses.

## Prepare briefings and strategic papers

Our clients need to prepare strategic position papers to assess the issues and prepare responses, whether it be internal restructuring, supply chain re-engineering or addressing policy risks. We assist our clients with short, impactful, and relevant position papers, including setting out the possible impacts of risks at different business levels (policy, financial, structural, etc.) and provide the latest thinking on the issues to date, based on a holistic economic framework.

## Undertake a full economic and legal review of the trade and investment exposures to worldwide events

We conduct independent and objective reviews of the impact of different worldwide events on your business and industry. We use deep learning tools, large multi-country macro models and the latest unstructured data to offer insights into the risks, exposure assessments and likelihood of disruptions to supply chain. These provide our clients with a competitive advantage as they prepare mitigation strategies and leverage identified opportunities. We work with our clients to develop the right strategies and make breakthrough decisions.

## Brexit: Help the private sector position itself during the UK's trade negotiations

Brexit will affect our clients' business strategies, supply chains, funding, tax positions, regulations, growth and opportunities. *International Economics* works with public affairs companies and specialized firms to offer the full range of trade-related technical support and advice to help companies position themselves and ensure that their interests are addressed in the negotiations.


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