SUSTAINABLE IMPACT ASSESSMENT OF THE EU-VIETNAM FREE TRADE AGREEMENT

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ABSTRACT

Formal negotiations between the European Union and Vietnam for a comprehensive free trade agreement began in June 2012 and were concluded in August 2015. The European Union has long been a major trading partner of Vietnam, with broad complementarity existing between the two. However, whilst average tariffs are relatively low between them, with a few notable exceptions for some sensitive sectors such as seafood and textiles and garments, a number of measures applied by each side restrict trade and investment in one form or another. This FTA Agreement is set to remove tariffs on goods traded between the two sides, as well as export duties by Vietnam, create new market access opportunities in services and investment, and liberalise Vietnam's trade in various services. From the analysis undertaken, it can be expected that this Agreement will benefit Vietnam greatly, with Vietnam projected to grow significantly as a result of inflows of capital and on-going productivity improvements.

THE NEGOTIATIONS

Formal negotiations between the European Union (EU) and Vietnam for a comprehensive free trade agreement (FTA) began in June 2012, following less successful earlier attempts with the Association of Southeast Asian Nations (ASEAN). In principle, these negotiations were concluded last summer, on August 4, 2015, pending the settlement of outstanding legal and technical issues[2]. A comprehensive study was conducted and completed in 2014, with a view to assisting the development of Vietnam's negotiating strategy, as well as to consult with the business community and concerned stakeholders regarding Vietnam's interests.

The FTA covers (i) Market Access for trade in goods; elimination of tariff and non-tariff measures, agreement on standards for key sectors, addressing SPS and TBT issues, trade facilitation and customs cooperation, and rules of origin (RoO); (ii) Commitments for the liberalisation of trade in services; (iii) Investment; (iv) Competition; (v) Government procurement; (vi) Regulatory environment; (vii) Sustainable development, including labour issues; and (viii) State-owned enterprises (SOEs) and the market status of Vietnam. The Agreement plans to remove nearly all tariffs on goods traded between the two as well as export duties by Vietnam; to create new market access opportunities in services and investment; and also includes the Vietnamese agreement to liberalise trade in financial services, telecommunications, transport, and postal and courier services[3].

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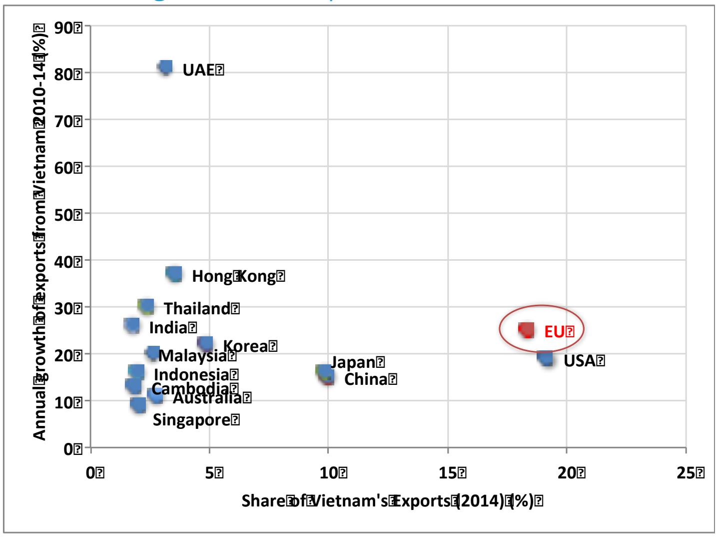
[2] See http://europa.eu/rapid/press-release_IP-15-5467_en.htm

[3] Ibid.

VIETNAM AND THE EU AS COMPLEMENTARY PARTNERS

The EU is a major trading partner of Vietnam, with Vietnamese exports reaching €22.2 billion in 2012, and imports from the EU reaching €6.2 billion in 2014[4]. Around one fifth of Vietnam's exports go to the EU, whilst 6 percent of Vietnam's imports originate from the EU. As a result, Vietnam has witnessed a growing trade surplus in goods with the EU. Since 2009, exports to the EU have grown by a phenomenal rate (23 percent per year) while imports from the EU have grown by only 7 percent per year over the same period. The net effect in the trade balance has been to raise the trade surplus by 34 percent per annum in favour of Vietnam.

Figure 1. Main export markets for Vietnam



Source: ITC Trade Map

Footwear, furniture, frozen fish and coffee make up the major exports from Vietnam to the EU, whilst the major imports to Vietnam include aircraft, cruise ships, motor vehicles and manufactured goods. Segmenting trade according to the WTO's definition of agricultural and non-agricultural goods leads to the observation that the greatest volume of trade is in non-agricultural goods, whilst trade in agricultural products is very low. Therefore, the trade surplus is proportionally higher in non-agricultural products, which is quite unusual to observe in trade patterns between a developing and developed country.

Statistics on services are limited but according to 2007 GTAP 8 statistics, whilst Vietnam enjoys a large surplus in travel and transportation services, it holds a deficit overall in commercial services with the EU, particularly in professional services. The EU put total bilateral trade in services at €2.9 billion in 2013, with a slight surplus for the EU[5]. Vietnam's trade in services has been relatively buoyant but has systematically recorded a deficit that has been growing in the last five years, reaching €1.4 billion in 2013.

Investment from the EU in Vietnam has also been significant, much in line with the large inflows from all countries since Vietnam joined the WTO in 2007[6]. Investment levels peaked at 40 percent of GDP after accession, and subsequently fell to around 20 percent, the lowest level since market reforms began[7]. Whilst FDI flows have recently slowed down due to the global financial crisis and

[4] See http://europa.eu/rapid/press-release_IP-15-5467_en.htm
[5] Ibid.
[6] See https://www.wto.org/english/thewto_e/acc_e/a1_vietnam_e.htm
[7] P. Baker (2015) Vietnam's International Trade Performance, in IEC, *International Trade & Investment Review*, Vol. 1, No. 1, February, p5

some overheating in the economy, they remain at around US$7 billion a year, with EU investors committing more than €1.3 billion in 2015 to become Vietnam's third largest foreign investor.

The degree of trade complementarity between Vietnam and the EU is quite high, being higher with the EU than some ASEAN countries, with the most significant exceptions being Japan and Malaysia[8]. Vietnam trades proportionately less with the EU than would be expected based on the importance of the EU in world trade. Therefore, there are expected to be major opportunities to expand trade between the two. Moreover, a simple static trade flow analysis indicates that there is potentially an additional US$100 billion, which could be generated in trade, if Vietnam could increase production (and exports to the EU) in products it currently exports to the rest of the world.

PROTECTIONIST MEASURES IN BOTH MARKETS HAVE CONSTRAINED THE LEVEL OF TRADE IN THE PAST

Vietnam's average tariff applied to EU products was around 10 percent prior to the Agreement. A few minor products retain tariff-rate quotas, such as those on eggs, sugar, tobacco, and salt. Vietnam's merchandise exports to the EU faced an average tariff of around 5 percent, although this hid a number of tariff peaks. The highest tariff rates are applied to garlic, at 300 percent, but there are also very high tariffs on beef and dairy products. Taking into account trade flows, the most significant tariffs in the EU are on textiles, clothing and footwear as well as frozen fish fillets; sectors where Vietnam enjoys very high comparative advantage. EU exporters to Vietnam also face significant barriers, with specific items experiencing peak tariffs, notably alcohol and tobacco products at 100 percent, as well as motor vehicles, particularly motorcycles, agricultural products and some textiles[9]. Aside from these peaks, tariffs remain relatively low between the EU and Vietnam. However, there are a number of measures applied by the EU and Vietnam which restrict trade and investment in one form or another. These behind-the-border restrictions include non-tariff measures (NTMs) related to SPS, and norms and standards on export restrictions. Beyond the number of NTMs actually initiated by the EU, 27 special safeguard mechanism instruments are also in force, whilst Vietnam also has a high number, particularly in the application of tariff measures and export taxes.

Both the EU and Vietnam have undertaken significant commitments at the WTO under the GATS. Vietnam undertook specific commitments in 11 services sectors (out of 12 categories) and 110 subsectors (out of 155) under the GATS. The Vietnamese also indicated that 100 percent foreign ownership is permitted in most of the services sectors and subsectors under Vietnam's GATS schedule. The EU undertook commitments in all 12 services sectors and in 115 subsectors (of the 155). Since the GATS, the EU has engaged in a number of bilateral FTAs which have gone beyond these commitments, and is looking to secure the same from its partners. In contrast, Vietnam's commitments in services in bilateral or regional agreements have not gone beyond their GATS commitments. It is important to note the degree of restrictiveness applied by countries in the field of services, as reported by the business community. The results reveal major restrictions applied by the EU for professional services, which are specific to each Member State. Vietnam also applies restrictions in mode 4 and maintains significant restrictions on mode 3 mainly through the

[8] P. Baker (2015) Vietnam's International Trade Performance, in IEC, *International Trade & Investment Review*, Vol. 1, No. 1, February, p6

[9] For further details on tariff rates see, P. Baker (2015) Vietnam's International Trade Performance, in IEC, *International Trade & Investment Review*, Vol. 1, No. 1, February, p7

requirement of joint ventures with a majority share for the Vietnamese party[10]. Vietnam also applies major restrictions in transport, which includes coastal shipping, as well as in communications. Significant reductions in current trade costs through liberalisation are necessary to bring Vietnam and the EU to the OECD average.

The FTA goes deeper on mode 4 liberalisation than either party has gone before in previous trade agreements, and both sides have made significant market openings in other modes for trade in services.

OVERALL, THE STUDY EXPECTS THE FTA TO BRING LARGE BENEFITS FOR VIETNAM

Using general equilibrium (CGE) and partial equilibrium models, the 2014 study[11] estimated the expected impacts arising from a negotiated FTA between the EU and Vietnam using a standard Sustainability Impact Assessment Framework with a time horizon until 2025. The study compared concessions made in other recent FTAs to determine the likely scenarios, with the main result emerging that Vietnam should benefit greatly from an FTA with the EU.

Vietnam is projected to grow significantly as a result of inflows of capital and on-going productivity improvement, with the FTA estimated to generate an additional 7-8 percent of GDP above the trend growth rate until 2025. The analysis indicates that the industrial sector in Vietnam will experience the largest net gains from an FTA, in particular the textile, clothing, and footwear sectors. Gains are also evident in agriculture, although meat and dairy production could be adversely affected. In general, Vietnam's exports to the EU are estimated to increase by around 50 percent by 2020, well above the growth in the base, with a further boost expected from full FTA implementation in 2025.

Using the GTAP model to simulate partial liberalisation of the services sector, it would be expected that services contribute to 24 percent of the output of Vietnam's economy compared with 42 percent for the goods sector. In the EU economy, by contrast, services contribute to 43 percent of output. In general, the increase in total trade in services is modest. Unlike the trade in goods, impediments in the services sector involve regulations rather than tariffs, so it is not always possible to model liberalisation by removing a tax as to do so would involve redistributing tax revenue that is not in fact collected. Therefore, the approach taken increases productivity in bilateral trade between Vietnam and the EU, which implies that the reduction in Vietnam's trade costs benefits the EU.

Investment flows, which are estimated to increase from the EU, are likely to lead to further dynamic gains. This could create large production shifts, which are not easily captured by the model and so the potential levels may be higher than predicted. Under a negotiated FTA, Vietnam's exports to the EU are estimated to increase by an additional 10 percent until 2025. However, the trade balance with the EU will deteriorate owing to additional imports of capital goods from the EU, although it will remain positive until 2025. The size of the trade balance will depend on the level of investment flows, intermediary inputs and other macroeconomic and monetary variables.

[10] For further details see, P. Baker (2015) Vietnam's International Trade Performance, in IEC, *International Trade & Investment Review*, Vol. 1, No. 1, February, p8

[11] Baker, P., Houng P.T.L., Vanzetti, D. *et al* (2014) Sustainable Impact Assessment EU-Vietnam FTA, MUTRAP, Hanoi, September

THE ENVIRONMENTAL AND SOCIAL IMPACT WILL LIKELY BE MODEST

The EU also recognises the value of upholding sustainability and environmental requirements in its trade agreements, and provides for an institutional framework and mechanisms to be established in order to monitor and review the application of the agreement and its effects on both parties, as well as settle disputes. However, the FTA is likely to have a very limited impact on the environment as Vietnam's growth will inherently be detrimental to CO2 emissions and other polluting issues. These environmental issues are best addressed with environmental rather than trade policies. The EU could support Vietnam in its efforts to mitigate externalities generated by its rapid economic transformation, but incorporating such provisions in a trade agreement would have very limited benefits and could be used as a means to introduce protectionist measures by the EU. Experience of using trade policies to target environmental goals, such as border taxes for carbon intensive goods, are often poorly targeted and distortionary, and in a bilateral case, they merely encourage trade diversion.

The FTA also seems to have a limited, albeit positive impact on reducing poverty levels in Vietnam. Vietnam's achievements in poverty alleviation have been extolled by the development community. This performance is forecast to continue, although it is expected that 51.9 thousand people escape poverty with implementation of the FTA.

CONCLUSION

The analysis undertaken suggests that the EU-Vietnam FTA will be very beneficial for the Vietnamese economy in general. There are some concerns about an increased trade deficit, a loss of tariff revenue and the cost of moving resources from declining sectors, but these concerns are manageable and outweighed by the potential gains. The monitoring of the implementation of commitments by both parties will be necessary to ensure that the agreement will be applied in a transparent and non-distortionary manner and that the full benefits are fulfilled.

ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations	**GTAP**	Global Trade Analysis Project
CGE	Computable General Equilibrium	**NTMs**	Non-Tariff Measures
EU	European Union	**RoO**	Rules of Origin
FDI	Foreign Direct Investment	**SOEs**	State-owned enterprises
FTA	Free Trade Agreement	**SPS**	Sanitary and Phytosanitary Measures
GATS	General Agreement on Trade in Services	**TBT**	Technical Barriers to Trade
GDP	Gross Domestic Product	**WTO**	World Trade Organisation

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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.

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