EU – Vietnam FTA Potential Impact Assessment
(Summary of findings of a MUTRAP study)

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1. EU-Vietnam trade relations

The report confirms that Vietnam is an **export-driven economy**, with 69% of GDP exported in 2008 (64% in 2009 and 61% in 2005); **16%** of the GDP value is exported to the EU, for a value of 14.9 bn. USD (14% in 2009 for 12.6 bn.) and it represents the 17% of all Vietnamese exports (constant from 2005).

The five first products exported into the EU (footwear – 4.5 bn., apparel and clothing 2.3 bn., coffee 1.4 b. , seafood – 1.1 bn. and furniture - 1 bn.) represent the 70% of total export to EU in 2008 (68% in 2009), with a the index of concentration (Herfindahl–Hirschman Index) equal to 0.12 (moderate level): therefore the exports to the EU are exposed to **industry shocks** as showed by the decrease of 15% of the export to EU in 2009 (-20% footwear, -26% coffee, -20% furniture while apparel and clothing limited the decrease to 10%).

Simple average **tariffs** applied by the EU on import of Vietnam are, in 2009, around 4.1% (decreased from 4.5% in 2005). Weighted average tariff, however, (tariff weighted with the level of trade) amount to 7%, meaning that higher tariffs are applied to relevant products exported from Vietnam (e.g. apparel and clothing: 11.7%, seafood: 10.8% and footwear: 12.4%) and very high tariff peaks (more than 57%). This means that the elimination of tariffs expected on substantially all the trade with the FTA will provide important advantages for Vietnam in comparison to other competitors in the EU markets. With regard to the tariff on import, Vietnam applied substantially reductions after WTO accession and now the simple average tariff is 9.3% (from 13.7% in 2005); the tariffs applied to the most exported products from the EU into Vietnam are quite low, with the exception of automotive (24.2%, electronics: 8.9%, mechanical: 3.4%, pharmaceuticals: 2%, Iron: 2%, optical and medical apparatus: 1.3%, aircraft: 0%). In all the mentioned categories excepted aircraft, however, there are quite high tariff peaks (from 10% of pharmaceuticals to 90% for automotive).

2. What expect from an FTA with the EU: the lessons from recent FTAs concluded by the EU

In its recent FTAs, the EU eliminated import duties on nearly all products and promoted a far-reaching liberalization of trade in services covering all modes of supply. The agreements included provisions on investment both in services and industrial sectors and strong disciplines in relevant areas, such as protection of intellectual property, public procurement, competition rules, transparency of regulations and sustainable development (i.e. environment and social rights). Other rules have been agreed on specific commitments to eliminate and prevent non tariff obstacles to trade in specific sectors (e.g., in the case of the agreement with Korea, automobiles, pharmaceuticals and electronics). The counterpart, normally, has to reduce the customs duties gradually and within a deadline of 10 years, with the possibility of excluding from the liberalization specific identified sectors. Regarding the technical and sanitary barriers the negotiation of an FTA is an important opportunity to discuss and deal with any problem faced by Vietnamese exporters in accessing the EU market.

3. The impact of the future agreement: the methodology

The report analyzed the impact of the future agreement utilizing a composed methodology: a **quantitative assessment** following the reduction of customs duties with a CGE model (Computational General Equilibrium) and a **qualitative assessment** conducted on three selected sectors of interest for Vietnam exports (footwear, garments and furniture) and three on Vietnamese imports (automotive, electronics and machinery and banking). The **quantitative analysis** has been conducted taking into consideration different scenarios: rapid dismantling, where 90% of the tariffs applied by Vietnam are eliminated for all goods imported from the EU and a progressive dismantling scenario (the more probable) where tariffs are eliminated progressively with different deadlines depending on the level of sensitivity of each product. For example, for non sensitive products (i.e. chemicals or machinery) it has been forecasted the elimination of tariffs in five years right after the entering into force of the agreement; for sensitive products the reduction has been delayed by 8 years, while high sensitive products (e.g. cars, motorcycles, etc.) have been excluded from liberalization. It is worth remembering that the impact of quantitative analysis is probably **underestimated** as it does not take into account the domino effects of the important institutional and regulatory reforms following the implementation of the agreement.

4. The quantitative analysis

The CGE models produced **positive results** for all the economic variables analyzed, in both the scenario analyzed (rapid and progressive dismantling).

The **fiscal revenue** would increase substantially as the revenue from the growth of imports exceed the losses due to the reduction of tariffs (529 bn. Dong yearly from the first year of liberalization in the rapid dismantling scenario and from 0 in the first year to 6305 bn. Dong after 15 years in the progressive dismantling one).

Exports would increase on average by 4% annually, with peak of more than 6% annually for sectors of interest for Vietnam which, at present, have to face relevant high tariffs on export to the EU, and 3% on average for the other sectors (this does not exclude that specific products might show higher data). Taking 2008 as a reference year, this means that the export to the EU will increase of more than 3.2 bn. USD in five years and more than 7.1 bn. USD in 10 years.

On average, **imports** would increase by 3.1%; among the most important import from EU, electronic and machinery +2.7%, chemical +2.5% and other industries, including pharmaceuticals, 3%). For the most sensitive products (footwear and garment and textiles) we consider relevant only the progressive dismantling scenario, as import tariff applied for these sectors will be probably the last to be reduced: in 10 years the import of footwear are expected to increase by more than 6% annually (10% in 15 years) while the increase of import of garments and textiles will be more limited (+2% and + 4.5% respectively in 10 and 15 years).

The model extended to the **agriculture** sector the hypothesis adopted for all the other products: therefore the outcomes (growth of import of 6.8% for livestock, 6.9% for vegetables and 6.3% for food products) have to be read taking into consideration that the liberalization of the agriculture sector will be limited.

The surplus of the **trade balance** with the EU increases in all the scenarios identified (up to 10000 bn. Dong in the rapid dismantling scenario); it should be noted that the improvement In the balance with the EU will cover the forecasted deterioration of the trade balance with China and Korea which is the consequence of the expected increase in the import of components and raw materials to be utilized for the manufacture of final products to be exported into the EU.

The impact on the **GDP** will be largely positive: around +2.7% yearly in case of rapid dismantling, while in the case of progressive dismantling there will be a gradual increase since the second year of implementation up to +3.7% after fifteen years.

Government and private consumption are expected to increase of more than 2% in both scenarios while investment would increase, respectively, of 2.3-2.6% in the case of rapid dismantling and up to 3.4% in the fifteenth year in the progressive dismantling one.

Prices on import and, as a consequence, composite prices (combination of domestic and import prices) are expected to decrease for all the imported products (less for machinery and electronics, which are the most important import from the EU) producing a natural increase of domestic consumption (2% both households and Government consumption).

Wages are expected to increase for the sectors that, at present, are less protected (machinery, electronics, chemical and the industrial sector in general). As the most protected sectors by Vietnam are also those for which Vietnam foresees important increase in exports, the final result on wages will probably be positive, due to the higher magnitude of the expected increase in exports than in imports. Regarding, in general, the strategy for liberalization, the model shows that a progressive dismantling scenario will bring about more positive results in the long terms than the rapid dismantling scenario.

5. Investment

The Vietnamese market is by one of the most attractive destination for FDI and is already receiving substantial amount of FDIs. Indeed, the total amount of **FDI in 2010** is estimated to be around **11 Billion** US$, up to 10% compared with 2009. Nevertheless, it seems that is the quality of the investments that is missing.

Vietnam has a lot to gain from a free trade agreement with the EU, both in terms of trade and also in terms of increased investment. From a qualitative analysis it seems that the biggest gains for Vietnam (in terms of volume and quality of FDIs, but also in terms of general economic benefits) would come from services liberalization.

6. Selected Importing Sectors

The Vietnamese **automotive industry** is still at its birth stage with only 25,480 cars produced in 2009. Compared with the 13,790,994 cars produced by China in the same year, it is clear that the automotive sector is not yet playing an important role in the industrial development of Vietnam. For what concern the automotive sector, a reduction of tariff and non tariff barriers from the Vietnam side will produce an effect on the imports of components from Europe and a limited effect on the amount of FDI. For what concern the import side, due to the cost of transport and the vicinity of competing car producers, a reduction in tariff will not induce substantial increase in imports of already assembled cars from Europe, as the benefit of a preferential tariff reduction will be offset by the cost of transport. This is not true for the imports of parts and components, which under some circumstances could be imported in great number from European manufacturers. Indeed, the price elasticity of parts and components is high and a reduction of tariff would theoretically have an impact on the exports. On the other hand, without a robust domestic industry and without European investors located in Vietnam requiring components to be assembled, even a reduction in tariff will have only a limited effect on the imports. For what concerns components the real factor influencing the little demand is the limited amount of investment in the Vietnamese automotive industry. This limits drastically the effect of a reduction in tariff. The FTA will have a little effect on FDI in the automotive industry.

Indeed, European car manufacturers seem to be little attracted by Vietnam as a productive platform for the ASEAN area. By looking only at the tariff component, the high protection accorded to the Vietnamese producers, combined with the parallel reduction in custom duties by the other ASEAN members and ASEAN FTA partners, would virtually render extremely cheap to export cars from Vietnam to the Asian region. Furthermore, the cheap labour available in Vietnam would be another important factor. In reality, tariffs preferences and cheap labour are not sufficient to drive investment in the car manufacturing industry. The deficiencies mentioned above (poor infrastructures, lack of support industries, low technology) clearly inhibit foreign investors to locate the production in Vietnam. In this respect, the reduction in tariffs on machinery and components could facilitate the inflow of European investment into Vietnam, but alone would not be sufficient.

In 2004-2009 Vietnam annual import turnover of **electronics** increased by 33.6% on average. From an import turnover of 2.6 bn. USD in 2005, after five years in 2008 it tripled reaching 7.6 bn. Conversely, in 2009 Vietnam totalized 2.6 bn. in export of computers and parts. The main export destinations in 2009 are: the European Union countries (47%), Saudi Arabia (14%), Brazil (8%), United Arab Emirates (7%), Canada (5%), Taiwan (4%) and Korea (2%). For what concern electronic sector, a simple business analysis would endorse the conclusion that a reduction in tariff would have definitely an impact on the volume and prices of electrical products and components imported from Europe. Indeed, a reduction in tariff would at least offset the costs of transport from Europe and give a great business advantage to European exporters vis-à-vis their Asian competitors from Japan, Korea and China that are already benefitting from lower distances and reduced import duties.

Over the years Vietnam has been constantly increasing its demand for high quality **machineries** and has thus relied heavily on importations. In 2008 Vietnam has imported 11.1 bn.USD worth of machinery. In this respect, the EU has around 14% of the market with 1.5 bn. of export to Vietnam. China is the biggest import partner with 2.75 bn. of export to Vietnam. For the machinery sector, a reduction of the already low tariff applied by Vietnam on the imports of machinery will not result in a substantial increase in imports. On the other hand, Vietnam could benefit from a consistent surge of FDIs from European manufacturers that could decide to locate here the production. Indeed, the growing domestic industries coupled with the general economic growth of Vietnam could have a domino effect on all the other support industries, which are now missing. In this respect, the general high quality of the European products could have an important market in Vietnam, and potentially also in the neighboring countries, such as Laos and Cambodia.

Currently, Viet Nam's **banking sector** comprises 5 SOCBs (Vietcombank, VietInBank, BIDV, Agribank, and Mekong Housing Bank), 40 JSBs (11 with foreign investors), 6 100% foreign-owned banks (HSBC, Standard Chartered, ANZ, Shinhan Vietnam Bank Ltd and Hong Leong

Bank Vietnam Ltd), 45 foreign bank branches, 55 foreign bank representative offices, and 5 joint venture banks. The banking sector will be one of the main targets in the context of further services liberalization required by the FTA. In this respect, there is no particular reason to foresee a huge increase of exports and FDIs in banking coming from Europe. The main reason for this resides in the fact that the Vietnam itself is not an attractive market for European banks that are not already massively present in the region. On the other hand, a further liberalization in cross border supply of banking services (MODE 1), without producing any significant impact, it could nonetheless allow Vietnamese individuals and institution to access the European banking market without the need for European banks to establish any form of presence in Vietnam. In the context of preferential liberalization in the FTA with the EU Vietnam could be required to adhere to some international financial stability standards. The upgrading of the Vietnamese regulatory framework required by the EU would be one of the most important effects coming from the FTA, as it was ten years ago with the BTA with the US, which opened the door for Vietnam to the entry into the WTO. One of the possible negative implications of a further liberalization could derive from a full opening of the capital account without the necessary prudential regulation and financial safety nets required to prevent a systemic crisis. In the context of the FTA would be wise to match an increased capital mobility with a parallel upgrading in the financial and monetary safety nets available to Vietnamese authorities.

7. Selected exporting sectors

The **textiles and garment**, one of the largest industries in Vietnam (more than 2 million workers in enterprises, mostly state-owned, concentrated in the South-East region – 58% - and in the River Delta – 27%) shows a high export propensity: more than 65% of production is exported to the US market, and the rest is exported mainly to the EU and Japan. Exports of garments showed a constant growth in the period 2005-2008 (+32% annually average) and a substantial decrease in 2009 (-10%) due to the demand contraction (and price reduction) following the economic crisis. The rising of prices of materials and high lending interest rates contributed to worsen the competitiveness of Vietnamese industry. The difficulties in exporting to the EU and American markets pushed the Vietnamese producers to look for niche markets such as Turkey, Middle East, Africa and Eastern Europe. Furthermore, due to the reduced tariff applied by Japan in the context of the ASEAN-Japan FTA, in 2009 the textile exports to the Japanese market increased of 25%. The ASEAN-FTA agreements will even mitigate the increase of costs of materials imported from Japan and Korea. Besides the international turbulences, the industry faces few challenges on the export side; in the next future the increased presence of products from China, India, Pakistan and Bangladesh will probably represent a the most important challenge for Vietnam. Besides the other advantages, the conclusion of the FTA will reduce to 0 the 12% tariffs at present applied by the EU on the export of Vietnamese apparel and clothes. This will benefit, in particular, the five most exported products (Women's and men's suits - 285 million and 233 million USD respectively, Men's and Women's overcoat - 211 million and 207 million and jerseys 166 million). Based on the 2009 data, the elimination of tariffs by the EU would produce an increase of export of the five most exported products above mentioned, on average, of more than 20%.

Footwear production (over 500 enterprises, one million workers) accounts for 40% of the total industrial production and has become a key export for Vietnam (10% of the export turnover, Vietnam is among the ten leading exporters in the world). In the EU, Vietnam is the second most important exporter after China (4.5 bn. USD in 2008; in 2009 the export reached 3.6 bn., down of 20%; China exports 10.5 bn., India and Indonesia around 1.5 bn. each); Vietnam exports concentrate mainly on high quality leather (48%, 2.3 bn. USD in 2008) and sport shoes produced for US and EU brands; recently few Vietnamese producers have started to focus on domestic demand by investing in the establishment of professional model design rooms. The share of EU import of Vietnamese footwear on the total import of footwear in the period 2004-2008 shows a "U shape" (11% in 2004, 9.3% in 2006 and 10.5% in 2008). The decrease in 2005 and 2006 is probably the result of the antidumping duty applied by the EU on the footwear with uppers of leather (even if the AD has been applied only in 2006, there has been an "announcement effect" as the procedure started in 2005); in this period Vietnam diverted part of its leather footwear exports to the US. However, in the same period China and other competitors increased their market share in the EU import (China: from 12.1% in 2004 to 21.1% in 2009; India +0.6%, Indonesia +0.5%): in 2009 the economic crisis impacted more on the Vietnamese (-1.1. of share in the EU market) than Chinese exports (+1.5% of share). Vietnamese exports of leather footwear are more sensitive to external shocks than Chinese ones: this is confirmed by the trend of export from 2006 to 2009 following the application of antidumping duties. The weighted average tariff applied by the EU on footwear imported from Vietnam is 12.4%: however, the tariff on import of leather footwear, including antidumping, is 17%. The losses in market share and the sensitivity of exports to external shocks make particularly important for the export of Vietnamese footwear the conclusion of a FTA: in the simulation with SMART (World Bank), the export of the different types of footwear would increase from 7 to 21%; to this it must be added an increase of 14-16% due to the forecasted expiry of the antidumping duty.

8. Trade Remedies and other Negotiating Issues

The negotiation of an FTA with the EU is expected, besides reducing and eliminating EU tariffs, to restrict the application of non-tariff barriers, too. The biggest non-tariff challenges affecting Vietnamese exports to the EU are connected to the EU's use of trade defense instruments, notably anti-dumping, and the EU's SPS and TBT measures.

As far as **trade defense** instruments are concerned, it is unclear whether the EU's negotiating proposal, in the context of the ongoing FTA negotiations, on anti-dumping and countervailing action will include provisions on enhanced co-operation and a set of WTO-plus obligations or will simply provide for a mandatory notification requirement and re-state the Parties' rights and obligations under the WTO agreements. The EU is unlikely to make concessions on anti-dumping and countervailing duties to Vietnam and the FTA will probably not have any significant positive impact on the EU's resorting to anti-dumping and countervailing action against it – on the contrary, it might pose stricter requirements to Vietnam in the area of dumping, subsidization and the use of trade defense instruments – unless the EU agrees, within the FTA negotiations, to recognize Vietnam as a market economy ahead of the WTO deadline. In the same way, an immediate recognition of its market economy status must stand as a negotiating priority for Vietnam in the context of the FTA with the EU. Should Vietnam not obtain from the EU its immediate recognition as a market economy, it should, nevertheless, negotiate with the latter an appropriate timeframe for such recognition and make sure that it is at least aligned with the WTO-mandate recognition of China as a market economy.

As far as **SPS and TBT** measures are concerned, it seems improbable that a reduction of SPS and TBT barriers will take place. Even after the launching of the "Global Europe" the policy of the EU has remained unaltered: it aims at tackling non-tariff barriers, but primarily for the benefit of the EU exporters. What is more probable is that the EU-Vietnam FTA will provide a framework for technical assistance, discussion and further co-operation on SPS and TBT issues. The importance of negotiating comprehensive co-operation provisions must be stressed. In this respect, the agreements concluded by the EU with ACP Countries may provide a useful benchmark on the extent of co-operation that Vietnam may wish to achieve with the EU on SPS and TBT matters. In these agreements, co-operation includes also technical support and training, and measures to promote knowledge transfer and strengthen public services. Vietnam may consider aligning its positions to what achieved by ACP Countries and request targeted technical assistance from to the EU in the context of its FTA negotiations.

Finally, Vietnam in order to reduce the costs of compliance with the EU SPS and TBT requirements Vietnam should actively seek the conclusion of mutual recognition and *ad hoc* equivalency agreements with the EU. Independently of the complexity to achieve these instruments of trade facilitation, it is clear that their pursuit, especially within the confines of an FTA, should be prioritized. Their conclusion, particularly in those sectors where Vietnam's exports have actual or potential market access opportunities on the EU market, stands to offer Vietnamese producers, exporters and traders considerable comparative advantages and "preferential" market access conditions which are comparable to or greater than the tariff concessions that will shape the EU-Vietnam FTA. These tools of trade facilitation will also allow for Vietnam to become an important processing center (for example, as it already happens, to import third countries' fisheries, such as Bangladeshi products, for processing in Vietnam under strict application of EU standards, and re-export to the EU) and take advantage of its ability to comply with relevant EU standards and its future FTA preferences *vis-à-vis* the EU.

As Vietnamese exports to the EU are frequently hampered by the imposition of NTBs by the EU, Vietnam could also consider advancing the introduction in the FTA with the EU of a dispute settlement mechanism specifically dedicated to counter NTBs, such as the "Mediation Mechanism for Non-Tariff Measures" envisaged under Chapter 14A of the EU-Korea FTA.

Finally, It is important that Vietnam thoroughly prepares its negotiating positions, including through the involvement of the business community and the relevant stakeholders, and secure that: its specific interests are furthered and that the different level of development between Vietnam and the EU is duly taken into account and factored in the negotiations.