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**Research Report**

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## Combining trade and sustainability? The Free Trade Agreement between the EU and Vietnam

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The European Union (EU) promotes the Free Trade Agreement with Vietnam (EVFTA) as an important milestone of its trade agenda. The agreement, whose part with EU-only issues is supposed to be ratified in 2019, is the most comprehensive one that the EU has concluded with a developing country so far, including an ambitious sustainability chapter. The reciprocal liberalization of tariffs and quotas will benefit important Vietnamese export sectors such as textiles, apparel, and footwear. On the other side, agricultural and industrial sectors in Vietnam might face increased import competition. Other provisions in the agreement such as the adoption of international or EU standards might be associated with adjustment costs. Thus, it will be crucial for Vietnam to promote its export sectors with pro-active upgrading policies. Further, the provisions in the sustainability chapter will have to demonstrate that increased trade and investment are compatible with labour and environmental protection. Both issues require substantive support by the EU.<sup>1</sup>

### Vietnam's integration into the global economy

From the late 1980s onwards, Vietnam has advanced the transformation of its economy towards a 'socialist market economy under state guidance'. This strategy implies a balance between the development of a new private sector, integration into the global market and attraction of foreign investment on the one hand, and the active role of government and state-owned enterprises (SOEs) for industrial development on the other hand.

Over the last three decades, Vietnam has experienced a structural transformation with an increasing share of industrial and service sectors in economic activity. Its export basket has moved from primary products to light manufacturing products such as electronics, footwear, and apparel (see Table below).

**Table 1: Structural Transformation Vietnam**

Share of GDP (in %)	1990	2000	2015
Agriculture	39	25	19
Industry	23	37	37
Services	39	39	44

Major Export Goods	1990	2000	2015
	Crude Oil	Crude Oil	Electronics
	Seafood	Footwear	Textiles and Apparel
	Milled Rice	Seafood/Fish	Footwear

Source: WDI Data

Changes in the trade relations of Vietnam with different trading partners are an indicator of this dynamic development, which resulted in annual real GDP growth of more than 6 percent between 2010 and 2017 (WDI Data). Vietnam was able to establish an increasing surplus in merchandise trade with the US (42 billion USD in 2017) and the EU (30 billion USD in 2017), while imports of goods from Asian trading partners (for instance, China and South Korea) exceed exports to these countries. In combination with surpluses in services trade, Vietnam has been able to achieve a positive current account balance in recent years.

### 'Uneven' EU – Vietnam trade relations

The EU has become an essential destination for Vietnamese exports. In 2017, Vietnam was the 10<sup>th</sup> important import source for EU countries, accounting for around 2% of extra-EU merchandise imports (UN Comtrade Data). The increasing trade flows from Vietnam to the EU consist in particular of electrical machinery and equipment, machinery, footwear, textile & apparel and green coffee beans and amount to almost 42 billion USD in 2017. On the other hand, although EU exports to Vietnam also exhibited dynamical growth adding up to around 12 billion USD in the same year, Vietnam maintained a significant trade surplus against the EU in terms of goods trade.

So far, Vietnam has enjoyed preferential access to the EU market. The EU grants Vietnam access under its General System of Preferences (GSP) with lower tariffs for the majority of tariff lines and duty-free and quota-free (DFQF) access for 'non-sensitive' products. Thus, 24.5% of tariff lines in EU imports from Vietnam are already fully liberalized, which translates into 59% of the trade volume going to the EU, including important sectors such as electronics and coffee.

Nevertheless, the EU charges relatively high tariffs on imports of dairy products, beverages as well as textiles & apparel, and footwear. Vietnam, on the other side, collects relatively high tariffs on agricultural products from the EU as well as on motor vehicles, but tariff barriers on chemicals and machinery imports are already low. Overall, trade-weighted average tariff burdens sum up to around 4% for both trade partners, even though tariff rates across sectors differ significantly (see Grumiller et al. 2018 for details).

### **Key contents of the EVFTA**

The EVFTA is a comprehensive trade agreement, which covers a wide range of trade- and investment-related topics, including trade in services, investment, government procurement state owned enterprises, competition, intellectual property rights, and sustainability. The agreement also plays an important strategic role for the EU as it is the first agreement with an ASEAN member state. In the following, the key contents of the EVFTA are highlighted:

#### ***Tariffs and Quotas***

As indicated above, the average level of tariff protection between the EU and Vietnam is already relatively low but differs across sectors, which has important implications for the expected economic effects of the EVFTA, as shown below. Both parties of the EVFTA commit to almost full elimination of tariffs and quotas with only a few exceptions remaining on both sides, mostly on agricultural goods. The liberalization schedules differ, however, with an extended transition period of up to 15 years for Vietnam compared to 8 years for the EU. Nevertheless, the vast majority of tariff lines will be eliminated with the start of the agreement and within the following 3 to 5 years on both sides.

#### ***Policy Space and Trade Remedies***

The EVFTA includes provisions that potentially reduce policy space, such as a non-revisable standstill-clause, a national treatment provision in accordance with Article III of the GATT 1994 and a limitation on the application of export taxes. In addition, bilateral safeguards are limited to anti-dumping measures, while other trade remedies, for instance, infant industry clauses, are not part of the agreement.

#### ***Non-Tariff Barriers and Trade Facilitation***

The EVFTA also includes chapters on non-tariff barriers (NTBs), technical barriers to trade (TBT), sanitary and phytosanitary standards (SPS) as well as customs and trade facilitation issues with the goal to enhance market access and trade between the parties. Most importantly, this involves the harmonization of product standards either to the international level or to the (higher) level of the respective trading partner. These adjustments tend to be more burdensome for the Vietnamese side, as the adoption of higher standards and necessary control mechanisms, for instance in the agricultural sector, involves costs in the short run. Besides, Vietnam's recognition of international standards in the automotive sector (UNECE regulations) leads to a far-reaching liberalization in this sector beyond tariff reductions.

### **Services**

Liberalisation of services trade focuses on the cross-border supply of services and enhanced access to many services sectors in Vietnam. However, there remain various limitations as audio-visual services, national maritime cabotage, and various air transport services are excluded. The agreement also lists various service (sub-)sectors, which still have certain limitations on market access and allow for discriminatory national treatment.

### **Investment**

The investment chapter in the EVFTA will replace the 21 existing bilateral investment treaties (BITs) between Vietnam and the EU and extends investment opportunities in specific sectors in Vietnam, including food production, beverages, and chemical products. In addition, the EVFTA extends access of EU investors to Vietnamese services sectors beyond current WTO commitments. Similar to other recent EU FTAs, investment protection is regulated via the new "Investment Court System" (ICS) dispute settlement mechanism. As this court system requires ratification by EU member states, the EVFTA text has been split into an FTA part falling under exclusive EU competences and a separate Investment Protection Agreement (IPA) (European Parliament 2018).

### **Competition, State-Owned Enterprises and Public Procurement**

The agreement aims to promote competition regulation in Vietnam that ensures equal treatment of foreign companies and subsidised Vietnamese SOEs. This topic has been sensitive for Vietnam, given that SOEs have traditionally been an important part of its economy and still generate around 40% of GDP. In addition, the agreement will lower barriers to access public procurement in Vietnam for EU companies, even though thresholds differ with regard to the type of public entities and type of services.

### **Sustainability**

The EVFTA also includes an ambitious and comprehensive sustainability chapter, which reflects the EU's vision and strategy to link trade and investment with sustainable development. The chapter addresses human rights as well as labor and environmental issues related to trade and investment. A two-pronged approach targets the interconnection between trade and investment, labour and environmental policies. On the one hand, the mutual supportiveness between these issues should be promoted, and, on the other hand, negative effects from increased trade and investment at the expense of workers' and environmental protection should be avoided. The essential tasks identified in the EVFTA include (i) recognition of the beneficial role of decent work; (ii) facilitation of trade and investment in environmental goods and services, which are relevant for climate change; (iii) development and participation in voluntary initiatives and regulatory measures to establish high-level labor and environmental protection; and (iv) promotion of corporate social responsibility.

In the EVFTA, the EU continues its ‘promotional’ strategy to achieve these sustainability goals by strengthening frameworks for dialogue, cooperation and monitoring of provisions, for instance with a Specialized Committee on Trade and Sustainable Development. This approach aims for voluntary measures adopted by private actors and intense engagement of civil society to monitor the implementation of labor and environmental clauses. In contrast to US FTAs, it does not include any sanctioning mechanisms.

Overall, the EVFTA improves market access for bilateral trade in goods, services, and investment. From a Vietnamese perspective, the comprehensive liberalisation of tariffs provides opportunities for certain export sectors, while agricultural and industrial sectors might face increased import competition (as analysed in detail below). Other provisions in the agreement might potentially be associated with adjustment costs, for instance, the adoption of international or EU standards as well as the liberalization of investment and changes of the regulatory framework for SOEs. Consequently, it will be crucial for Vietnam to promote its export sectors with pro-active upgrading policies and to use the EVFTA for its sustainable development. The sustainability chapter of the EVFTA and its opportunities and boundaries will therefore be highlighted below.

### Estimated economic effects

The simulation with the ÖFSE Global Trade Model, a structuralist Computable General Equilibrium (CGE) model is limited to potential effects on macroeconomic and sectoral variables following the liberalization of tariffs and quotas.

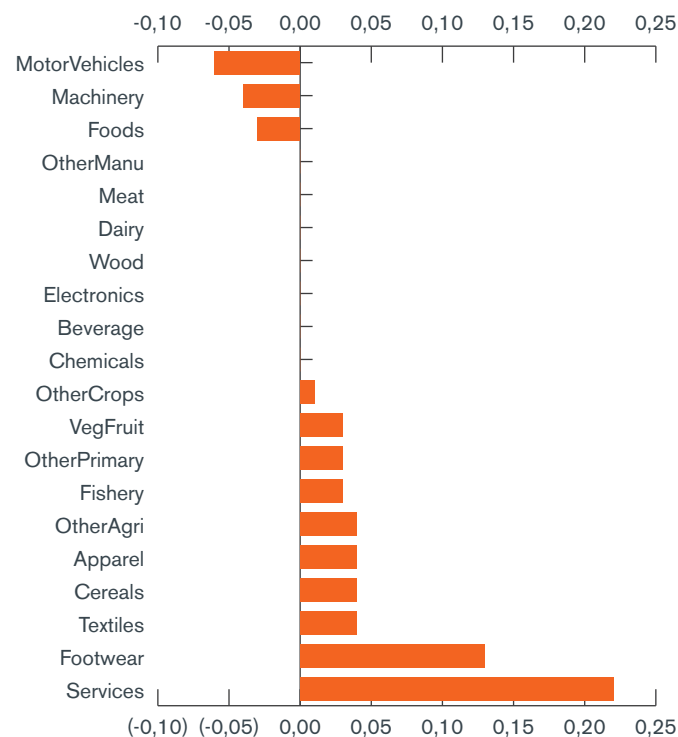
Even though average EU tariffs on imported goods from Vietnam are already on a relatively low level of around 4%, protection for textiles & apparel, and footwear, as well as selected agricultural goods and foods from Vietnam, are still high. Thus, tariff liberalization in these sectors, which represent an important share in Vietnamese production and exports to the EU contribute significantly to the positive effect for Vietnam as a whole. Vietnam’s real GDP is expected to increase by 0.48%, while the GDP of the EU remains unchanged due to the minor significance of EU exports to Vietnam and the relative size of the EU economy.

The breakdown of the GDP growth into sectoral contributions reveals these concentrated effects on a limited number of sectors (see Figure 1). These include textiles, apparel, and footwear as well as several agricultural sectors that all benefit from enhanced market access to the EU. Even though the service sector is not directly affected by tariff liberalization, services as intermediate inputs and as part of private consumption benefit from multiplier and consumption effects. On the other side, there are several sectors, which show negative contributions to GDP, including motor vehicles, machineries, foods, meat, and dairy, due to the replacement of domestic production by EU imports.

Despite these relatively small adverse effects in individual sectors, broader implications for the livelihood of farmers and consumers (foods) as well as for industrial development (motor vehicles, machinery) need to be taken into account,

which might require adjustment assistance to cushion negative effects.

Figure 1: Sectoral contributions to growth in Vietnam



Source: CGE calculations

The sectoral concentration in Vietnam is also reflected in effects on exports and employment. While exports from Vietnam to the EU increase by 7.2% (equivalent to an increase in total real exports of 1.5%), this is largely driven by exports in textiles, apparel, and footwear. As these sectors, as well as the services, are labor intensive, there is a positive overall change in employment in Vietnam, which amounts to 0.88% and this is even stronger than the change in real GDP.

The removal of duties also affects public revenues. In the case of Vietnam, our model simulations, however, show that foregone tariff income will be rather low, accounting for 0.28% of GDP, which is not expected to lead to substantial fiscal policy challenges.

### Pro-active policies for upgrading in export sectors

As shown in the model analysis, tariff liberalization via the EVFTA is expected to contribute to growth and employment creation in Vietnam through positive effects in already important export sectors. However, it is not possible to cover the comprehensive issues covered in the EVFTA in such an economic modelling exercise. The indicated export potentials thus require further scrutiny.

In our report (Grumiller et. al. 2018), we provide an in-depth analysis of crucial export sectors for Vietnam, namely the production of seafood in aquaculture as an example for an agricultural sector and the textile & apparel (T&A) sector. In both cases, the conducted global value chain analyses show that the possibilities of these sectors to contribute to the

sustainable development of Vietnam crucially depend on the ability to upgrade. This requires however the support with pro-active policies on a national level and via development cooperation.

Our analysis points to the need for policy interventions in two priority areas:

*a. Export potentials for food products depend on investment in processing and branding activities and in quality infrastructure*

In the Vietnamese aquaculture sector, the EVFTA enhances market access due to tariff liberalization for unprocessed as well as processed shrimp and pangasius products, albeit with different and longer liberalization schedules for higher value-added products. GSP tariffs currently range from 4.2% to 8.5%. Although the aquaculture sector does not profit from relaxed Rules of Origin (RoO), e.g. regarding changes in product rules or cumulation possibilities, the improved market access brought about by the EVFTA is likely to increase exports to the EU.

Given that most global value chains (GVCs) for agricultural and food products are buyer-driven, increases in export revenues need an approach that aims at extracting more value-added from each unit exported. This is particularly the case, where further increases in export volumes are constraint by production conditions, e.g. water scarcity, which might also lead to negative environmental externalities. Export-oriented upgrading activities, in particular processing of e.g. shrimp or fish into ready-to-eat products, do not only need investment in processing facilities but in particular marketing and branding strategies in order to gain access to retailers and become attractive to final consumers.

Trade policy can support upgrading both by improving market access, e.g. by eliminating remaining tariffs and quotas, and furthermore, by supporting to meet standards, both public SPS and private standards of lead firm in GVCs, in particular, quality standards and certifications for organic products.

*b. Promotion of upgrading and of the textile sector is of strategic importance in the apparel sector*

The EVFTA will significantly enhance market access and thus increase the competitiveness of Vietnamese apparel exports to the EU. Vietnamese apparel exports to the EU are currently subject to GSP tariffs of between 8.5% and 9.4%, and the EVFTA will grant DFQF access over a transition period of eight years after the agreement comes into force. The GSP RoO demand double transformation (fabric forward) for Vietnamese apparel exports and the EVFTA will not bring any improvements in this respect. This implies that Vietnam will not be able to source fabrics from China and other essential textile suppliers, but instead will have to rely on local or EU textile suppliers in order to export DFQF to the EU. The EVFTA, however, grants cumulation for Korean fabrics in the context of the EU-Korea-FTA.

The apparel sector has been facing continuing preference erosion as more countries are receiving preferential market

access to the EU due to the proliferation of FTAs. In addition, reduced lead times and the trend to fast fashion characterise the sector. Thus, the sustained competitiveness of the apparel sector in the future will not primarily rest on the availability of cheap labour and DFQF market access, but on the availability of a flexible and high-quality production system that extends from the production of yarns and fabrics, the availability of accessories and finishing services to modern logistics and transport services. Apparel production in Vietnam should therefore increase its efforts to position itself as a more developed apparel supplier, extending their role from cut-make-trim (CMT) production and lower value products to increasing local value-added and linkages. This will involve investments in the build-up of a domestic textile sector, but also extend to other supporting services, e.g. increasing the availability of working capital for FOB production and productive investment credits as well as improving the technical skills of workers.

### Trade and sustainable development

Sustainable development as defined by the UN Agenda 2030 and adopted by the European Consensus on Development, calls for the promotion of sustainable economic growth that is socially inclusive, respects ecological boundaries and promotes peace and democracy. The sustainability chapter of the EVFTA aims to ensure that trade liberalization is a means of achieving sustainable development. Our estimations have shown that small, but positive growth effects from tariff liberalization may well be expected for the case of Vietnam. The extent to which growth is socially inclusive depends on a multitude of factors, both domestic and international. Four issues require specific attention:

1. The EU approach aims to promote human rights, labour and environmental standards via dialogue and coordination processes. This requires effective monitoring structures and consultation process adjusted to local circumstances. Our analysis concerning the T&A sector and aquaculture sectors in Vietnam has shown that particularly apparel and agricultural workers, who are to a high degree women, represent vulnerable groups, whose rights need particular attention. However, both political interests and civil society actors are rather weak, which will impede the implementation of the provisions of the sustainability chapter. A full realization of the potential will therefore need a higher dose of ownership on the side of EU institutions, and more support for cooperation between EU and Vietnamese civil society under EU development cooperation and Aid for Trade programs.
2. An important aspect of social inclusiveness relates to the potential of trade agreements for promoting employment and decent work, i.e., employment that pays living wages and fosters good working conditions. Our analysis suggests that on balance the EVFTA will produce some employment gains, though not in all sectors of the economy. It is important to ease the social adjustment costs concomitant to that process, which requires adequate funding. Further, quantitative employment effects say nothing about the qualitative aspects of the jobs created. The case study sectors are particularly prone

- to problematic working conditions in terms of low wages or prices, long working hours, compliance and restricted representation and collective bargaining. These labour issues are related to dynamics in the GVCs, where competition is high and costs, quality, lead times and flexibility requirements of global buyers stringent. However, they are also related to country-specific contexts. In addition, private buyer-driven CSR initiatives are important. To have a sustained effect they need to be independently monitored and aligned with sourcing requirements of buyers. Further cooperation with local labour inspectors and labour ministries as well as trade unions is of crucial importance, which should be developed in the context of the Sustainability Chapters of the EVFTA.
3. With regard to the environmental impact of trade liberalization, a systematic and comprehensive analysis has been beyond the scope of this study. Other assessments of the EVFTA, however, suggest that on balance adverse environmental effects in particular with respect to emissions will likely prevail, though this depends on a number of developments, in particular, the sectoral specialization patterns, and is thus difficult to estimate for the long run (ECORYS 2009). With respect to the case studies covered in our report, we have argued that instead of an increase of unprocessed exports of shrimp and pangasius in the case of Vietnam, which clearly would have negative environmental repercussions, the challenge consists in extracting more value-added from the export-oriented production of these commodities. If managed properly, this would arguably also promote more sustainable production models, as consumers in Europe increasingly demand organically grown and sustainably harvested food products. EU development cooperation should support the ecological orientation of these value chains and facilitate branding and marketing activities for the establishment of high-quality products in buyer-driven value chains, where lead firms are mostly residing in the EU. For the T&A sector, particularly water pollution related to the disposal of chemicals and washing water is a crucial concern. In the context of the strategically important development of a local textile sector, environmental issues have to be seriously addressed.
  4. Finally, the political dimension of sustainable development is crucial. In Vietnam, there is an ongoing political transformation where liberal economic reformers are struggling with China-oriented conservatives over the economic and political future of the country. Trade agreements play an important role in this broader transformation process, since they are used mainly by liberal reformers to support national liberalization agendas as well as by NGOs to push for labour rights particularly in the context of the Sustainability Chapter.

Even though the sustainability chapter of the EFVTA is comprehensive, its implementation will be a challenge in the Vietnamese context. Adequate political, as well as financial support, by the EU is therefore necessary to avoid the risk that the sustainability chapter is nothing more but a mutual declaration of goodwill.

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WDI Data (n.d.): World Development Indicators, The World Bank. Washington D.C.

- 1 This policy note builds on the results of a comprehensive study (Grumiller et al. 2018) conducted by the Austrian Foundation for Development Research (ÖFSE). The economic assessment is based on simulations with the ÖFSE Global Trade Model, a structuralist Computable General Equilibrium model. The qualitative analysis and cases studies draw on text and data analysis, literature reviews and interviews in Vietnam.

#### Disclaimer:

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