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DIRECTORATE OF INTELLIGENCE

# Intelligence Report

## *The Economic Situation in South Vietnam*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence

# The Economic Situation In South Vietnam

## Summary

On 3 October the Vietnamese government announced an economic reform program designed to improve the morale and effectiveness of government employees, to contain inflation, and to curb profiteering by importers. The measures enacted include a partial devaluation of the piaster and a wage increase for the civil service and the armed forces. Their impact should be salutary, but basic forces causing inflation and inequities in incomes will remain, and gains will be short-lived unless the government takes further action. Even so, US aid will remain the main stabilizing influence on the economy.

Retail prices in Saigon increased very little following the announcement of the reforms. On 12 October the USAID retail price index was no higher than it was in early September. Following the establishment of the new foreign exchange rate of 275 piasters to the dollar, the black market rate rose to 448 piasters per dollar on 12 October.

Charts on prices and money supply, import licensing, currency and gold prices, the government budget, and foreign exchange reserves follow the text.

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*Note:* The Economic Situation In South Vietnam *will be published monthly. The next issue will appear on 16 November 1970.*

Recent Economic Reforms

*Background*

1. During the past year the South Vietnamese economy has suffered from a crisis of confidence. Expectations of devaluation as a result of four years during which the price level almost tripled while the exchange rate was constant, rice market difficulties, and uncertainties caused by US withdrawal created a speculative climate that resulted in rapid price increases and loss of confidence in the piaster. Retail prices increased about 45% during the past 12 months, and the black market price of the piaster rose to a level three and one-half times the official price. The government's inability to deal strongly with these problems contributed to the lack of confidence. Inept handling of a major tax increase on imports last October led to further speculation and resulted in the cost-of-living becoming an important source of dissatisfaction with the Thieu government.

2. In addition to speculation, basic inflationary pressures have been at work. The buildup of the armed forces associated with the Vietnamization program and the funding of programs such as veterans' benefits are contributing to a growing budget deficit. Revenues from imports began to fall off in July as the government's cutback in import licensing earlier in the year caused import arrivals to decline. Collections of domestic revenues, such as income and excise taxes, have increased considerably this year, but the revenue base is small, and collections are not expected to increase much more than the rate of inflation. Above all, the government realized some time ago that a wage increase for the civil service and the armed forces could not be delayed much longer. These groups, whose support and effectiveness are vital to the Thieu government and to the success of the Vietnamization program, have suffered a 40% to 50% decline in real income during the past five years, most of it concentrated in the past year. A pay increase for government employees, therefore, was considered imperative, and means had to be found to finance it.

3. Last May, President Thieu asked the National Assembly to give him decree powers over economic matters for a period of five months so that he could enact a major stabilization program. Not until 29 September, however, did the bill clear the legislature and then only in greatly modified form. The modified bill contained no provisions for increasing taxes, but it did provide that Thieu could establish a second, higher foreign exchange rate for a wide range of transactions. With this limited but politically crucial backing from the National Assembly, Thieu announced, effective 5 October, a partial devaluation of the piaster as well as other measures, for which he needed no legislative approval. The latter included higher duties on imports of luxury goods and agricultural inputs, liberalization of import licensing, higher official prices for imported rice in Military Regions I and II, and a pay increase averaging 17% for government employees.

*Reform Measures*

4. The devaluation does not affect the exchange rate for most imported goods or for US government purchases of piasters for official use, which are the most significant transactions. In 1969, for example, imports of goods accounted for about 80% of total foreign exchange expenditures on current account, and US government purchases of piasters for official use amounted to about 60% of total exports of goods and services. For these two items the exchange rate remains 118 piasters per dollar -- the official rate. A second exchange rate of 275 piasters per dollar, however, now has been established to apply to purchases of piasters by US personnel in Vietnam as well as to exports, imports of luxury goods, and invisible transactions such as profit remittances and foreign investment. The new rate for US personnel should draw some dollars away from the black market and into government hands, but will be of little other benefit to the Vietnamese. A higher exchange rate normally would encourage exports and foreign investment, but South Vietnam currently has little to export and holds little attraction for investors. The higher exchange rate for imports of luxury goods, such as Hondas and refrigerators, should, however, tend to discourage purchases of these goods and reduce importers' profits. Luxury goods have accounted for 10% to 15% of total imports during the past several years.

5. Despite the National Assembly's refusal to grant President Thieu power to change tax rates, the government believes it has ample precedent for levying or adjusting the perequation tax on imports -- a form of customs duty collected by the National Bank of Vietnam rather than by the customs service -- without legislative approval. Thieu, therefore, increased perequation taxes on many imported luxury items and agricultural materials, such as pesticides, tractors, and small engines. The most important agricultural input -- fertilizer -- was exempted because there reportedly already exist large amounts of unsold fertilizer, and officials fear that higher fertilizer prices will discourage its use, and consequently slow the increase in rice output. As a result of the higher tax rates, government revenues from perequation taxes, which probably will total roughly 20 billion piasters in 1970, are expected to increase by about 14 billion piasters in 1971.

6. In an attempt to increase competition among importers and thereby eliminate excess profits, the government announced plans to ease requirements for the establishment of new import firms and eliminate restrictions on the quantities and types of goods that may be ordered. With a view to curbing speculation, importers now are required to make large advance deposits -- in some cases more than 100% of the foreign exchange cost -- on orders for some goods. This latter move ties in with the higher interest rates announced last month by the National Bank, which are designed to encourage savings and make it more costly for importers and others to engage in speculative activities. The National Bank raised its rediscount rate for most commercial paper from 7% to 18% and removed ceiling rates on commercial bank loans and deposits. Commercial banks then announced new interest rates on loans ranging from 14% to 24% per year, compared with former rates ranging from 8% to 14%. Rates on 12-month time deposits were raised from 12% per year to 20% per year.

7. To reduce inequities in the rice market, the government raised the official price of imported rice in Military Regions I and II to the same level that prevails in Saigon. The chief intended consumers of imported rice in Military Regions

I and II -- civil servants, soldiers, and their dependents -- receive the same pay and allowances as their counterparts in Saigon, and officials apparently concluded that with improved security the northern provinces no longer require special treatment. In any case, the low prices frequently were not passed on to consumers, because of corrupt practices by the provincial and military officials and the few favored merchants who handle distribution. The government reportedly plans to open up the rice trade to any licensed merchant who wishes to participate, but it is not known when this reform is to take effect.

8. The 17% wage increase for civil servants and the military will cost about25 billion piasters on an annual basis, or 13% of planned total expenditures in 1970. The pay increase, however, will by no means make up for the severe loss in real income government employees have suffered during the past five years, and especially last year. Prices have risen about 55% just since the last government pay increase in July 1969. Moreover, at least some of the new wage increase will be offset by further price increases. The wage increase itself, which, including dependents, affects roughly one-third of the population, probably will push up the general price level somewhat. Prices doubtless will increase for goods affected by the higher taxes and exchange rate, and past experience suggests that other prices also will rise. The government hopes the impact will fall mainly on the urban rich and to some extent on farmers, whose real incomes have risen substantially during the past year or so.

*Evaluation*

9. The program enacted by the government is designed to improve the morale and effectiveness of government employees, to contain inflation, and to curb some of the blatant profiteering by importers. Its impact should be salutary but basic forces causing inflation and inequities in incomes will remain, and gains will be short-lived unless the government takes further action. Because the new, higher interest rates still are below the rate of inflation, they probably are not high enough to encourage savings and discourage speculation. The effective exchange rate (the official rate plus import taxes) for many imports remains too low

compared with the domestic price level. It is estimated that the combination of the new, higher exchange rate and higher taxes for some imports amounts to an average effective devaluation of about 15% for all imports, excluding rice. This change, in addition to the various increases in import taxes in recent years, has doubled the effective exchange rate since the 1966 devaluation, but the domestic price level has tripled in the same period.

10. The creation of a dual exchange rate adds to the government's administrative problems, which already are considerable because of the complicated structure of import taxes. Such a system lends itself to evasion. Smuggling of goods subject to the higher exchange rate and taxes is likely to increase, and demand for dollars on the black market to pay for the smuggled goods also will increase -- a repeat of developments that followed the increase in austerity taxes on imports in October 1969. Moreover, there might be some incentive to assemble or produce luxury goods domestically from imported materials and components not subject to the higher rates. The government cannot simplify the import tax structure, however, without authority from the National Assembly.

11. Perhaps most crucial to the success of the reform measures is the degree to which import licensing is opened up. Restrictions on the quantities and types of goods that may be imported have resulted in retail prices for many imports considerably above importers' costs. Although these costs now have been raised by the higher interest and exchange rates and by higher taxes, the importers simply will pass on the increase to consumers if government restrictions on licensing are not eased. Unfortunately, the government reportedly has delayed opening up licensing because officials already are having trouble coping with the dual exchange rate and the new system of advance deposits. Moreover, efforts to increase competition among importers may not be successful. A relatively small number of companies apparently account for a large proportion of the import trade, and they probably will use their considerable influence to maintain the status quo. Finally, with most imports still at the low official rate, the demand for imports still may considerably exceed the supply of foreign exchange. If this is so, open licensing, once introduced, could not be sustained.

12. The adoption of a uniform official price for imported rice throughout the country is just the first step in a rationalization of the rice market. Eventually, all price controls on imported rice will be abolished. If the country's output of rice continues to increase as rapidly as expected, the sale of large amounts of imported rice to government employees at prices below the free market level will discourage marketing of domestic rice and thus perpetuate imports. Moreover, the present pricing and distribution system for imported rice is extremely difficult to administer and is open to corruption. The government has indicated that it plans a series of price increases for imported rice which eventually would bring the price of imports in line with prices of domestic rice.

13. Increases in the official price of imported rice probably will have to be accompanied by at least offsetting increases in pay for government workers if their real incomes are to be prevented from deteriorating even further. Moreover, the morale and performance of the civil service and the armed forces depend not only on increasing their real incomes but also on reforming the government wage structure. Pay increases should be given as a percentage increase of the employee's base pay rather than being added on to family and cost-of-living allowances as has often been done in the past. The pay structure now is heavily weighted in favor of employees with large families and does not provide incentives for improved performance or promotion. The increase granted this month reportedly was split between base pay and allowances.

14. As expenditures rise, revenues to cover them will be difficult to find. Although the civil service and the military forces experienced the largest decline in real wages during the past year, urban workers in general suffered. The dissatisfaction of these two groups has become a major political problem. Therefore, the government's attempts to raise revenues will have to be aimed increasingly at the urban rich who have benefited from the war -- importers, merchants, and property owners -- and at the farmers in secure areas who have been getting high prices for their output and no longer must pay rent. But the government is not now administratively capable of systematically

collecting taxes either from farmers or the urban rich. Moreover, so long as the currency is overvalued and restrictions on imports are maintained, opportunities for making large windfall profits will continue to exist.

15. To a great degree, the effect of the recent reform measures depends on psychological factors that are not predictable. It is impossible to say whether expectations of further rapid inflation and/or devaluation, which tend to be self-fulfilling, will be encouraged or discouraged by the government's action. The new measures were widely publicized before hand, however, and early reaction -- in terms of price increase and public outcry -- has been much milder than that which followed the austerity tax increase a year ago. If the price increases -- and thus political repercussions -- that result are not large, the government could take additional stabilization measures during the next year which would not require legislative action. More imports could be shifted to the new exchange rate and further adjustments could be made in interest rates, import deposits, and perequation taxes. The Vietnamese, however, have exhibited little flexibility on these matters in the past, and with the presidential election coming up in 1971 it seems unlikely that President Thieu would be willing to incur many additional political risks. Taking into account Vietnamese political considerations and the US government's desire to see Vietnamization succeed, the major stabilizing influence on the economy will have to continue to be US aid, which will increase by about $100 million to a total of about $750 million in 1971.

Prices

16. Retail prices in Saigon increased very little immediately following the announcement of the reform measures on 3 October. The USAID weekly index rose 2% during the week ending 5 October and another 2% the following week. The overall price level on 12 October, however, was no higher than it was in early September, or 30% above the average price level for December 1969. The retail price index includes mainly domestically produced goods, which were not directly affected by the reform measures. Data on changes in the prices of imported goods since 3 October are not available.

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Currency and Gold

17. Saigon black market prices of dollars and gold increased following the establishment of the new parallel exchange rate of 275 piasters per dollar. The price of dollars rose from 426 piasters per dollar on 29 September to 448 piasters per dollar on 12 October. The price of a dollar's worth of gold leaf increased from 505 to 545 piasters during the same period.

18. As a result of the recent devaluation, American and other foreign military and civilian personnel working for US agencies and their contractors, who are paid in Military Payment Certificates (MPCs), may now legally exchange their MPCs for piasters at the rate of 275 to 1. (MPCs are officially on a par with the dollar and are legal exchange only in US installations for authorized personnel.) Following the change in the exchange rate, a new series of MPC currency was issued on 7 October. On 12 October the black market rate for the new MPCs was 310 piasters per dollar, or 13% above the new official rate.



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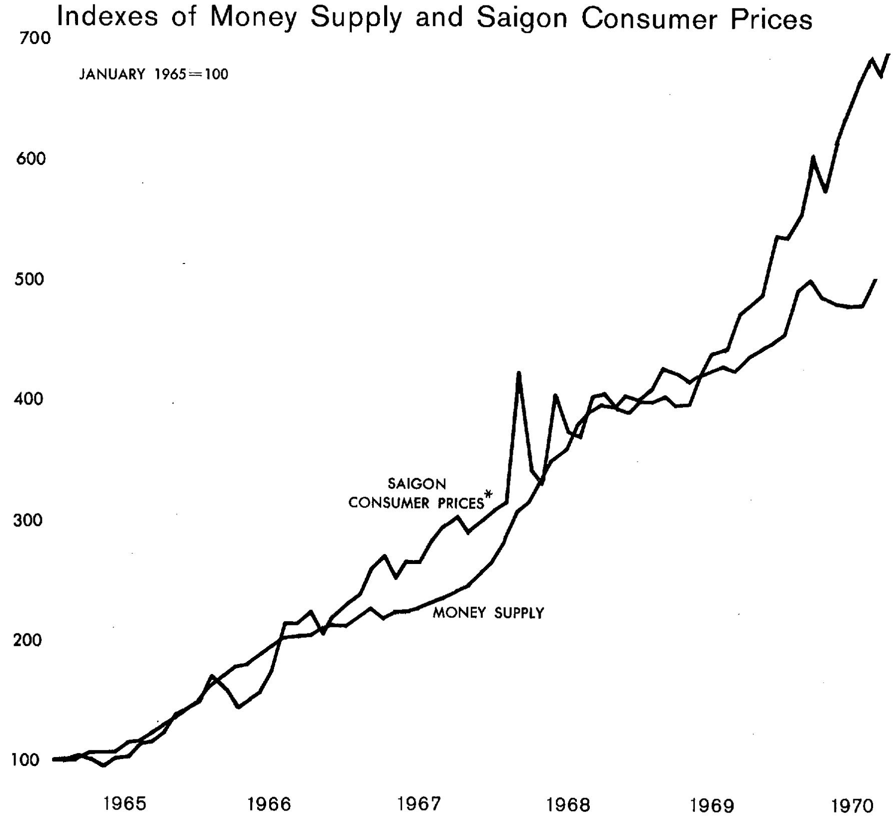
## SOUTH VIETNAM
Indexes of Money Supply and Saigon Consumer Prices




*USAID monthly average retail price index for Saigon

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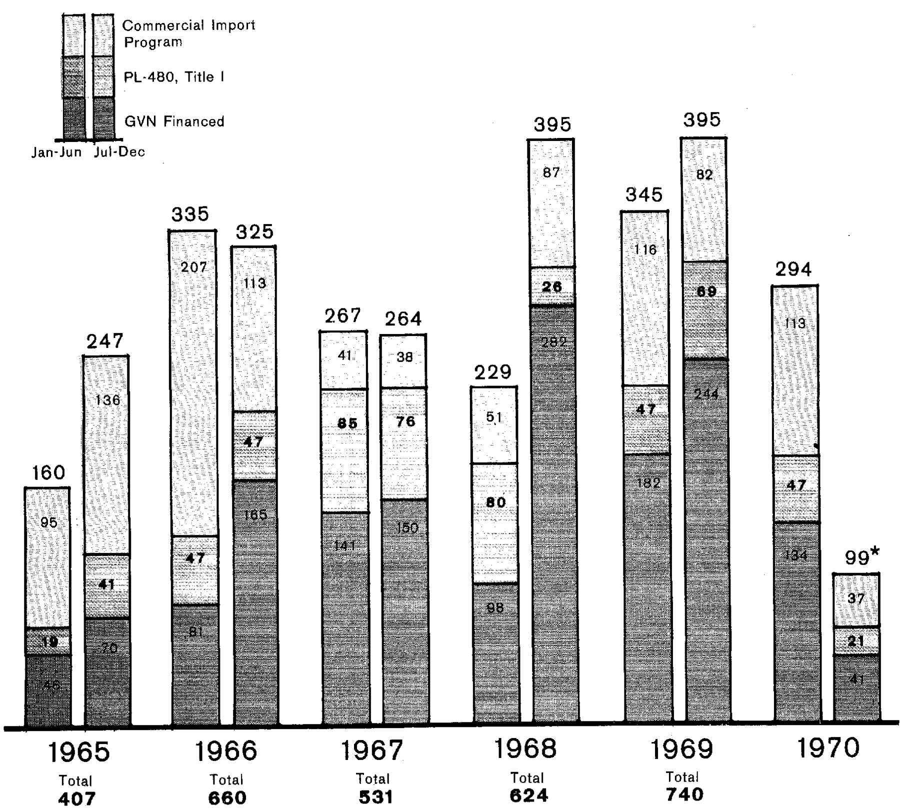
# IMPORT LICENSING

(Millions of Dollars)




*July and August only

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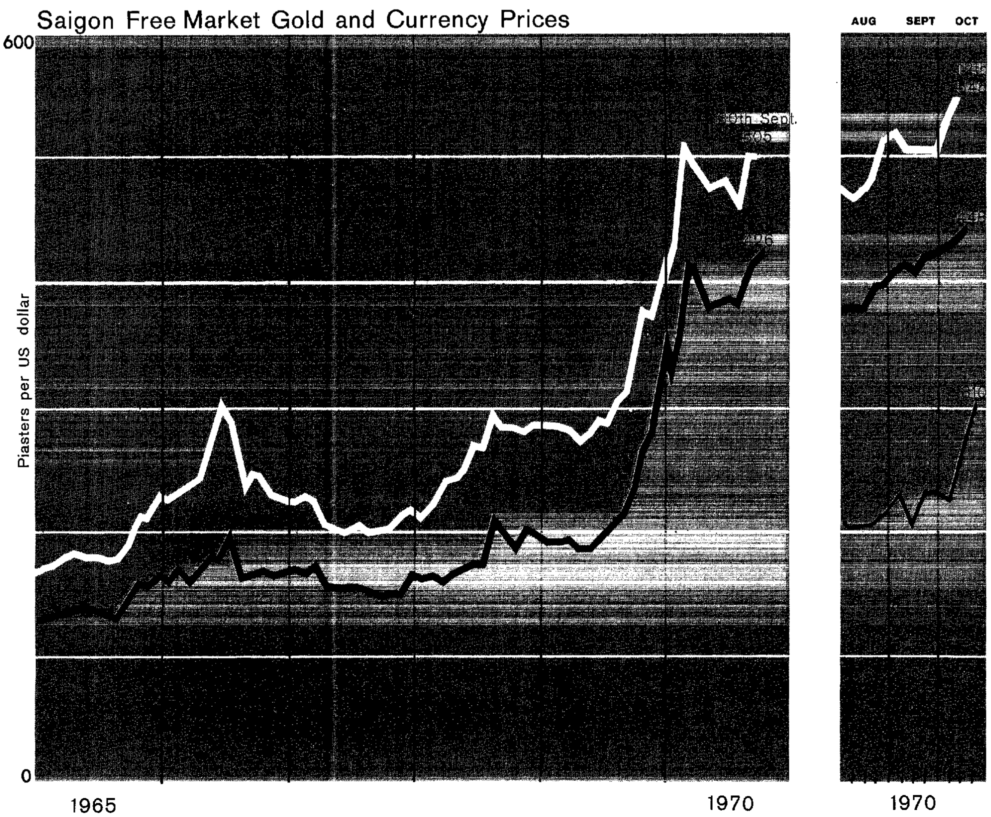
Saigon Free Market Gold and Currency Prices




GOLD Basis: gold leaf worth $35 per troy ounce

US $10 MPC Military Payment Certificates (scrip)

US $10 GREEN

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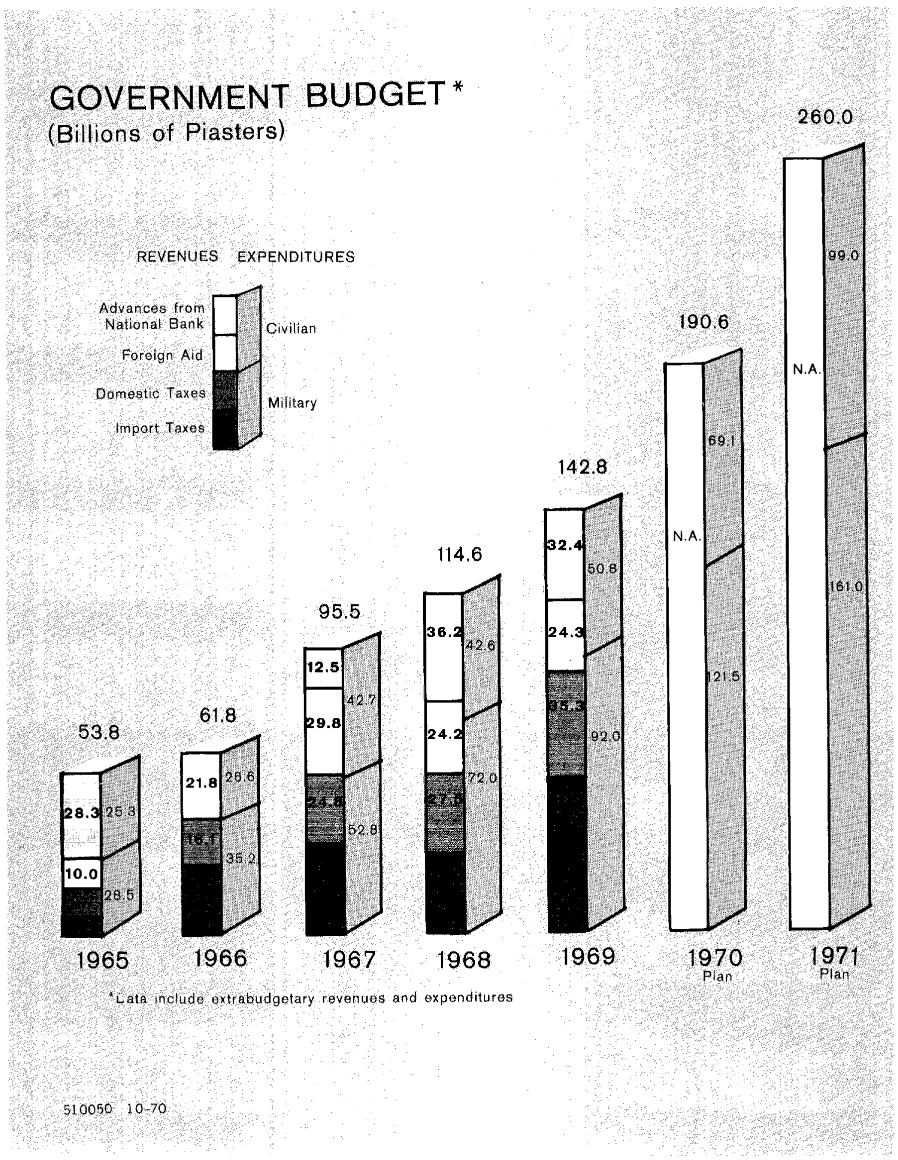


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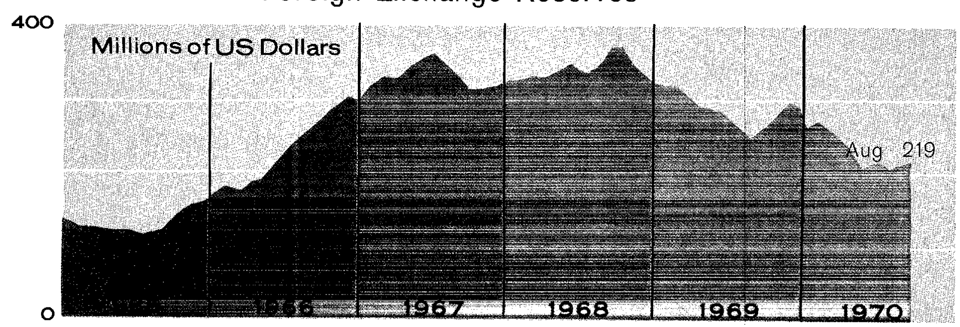
South Vietnam: Foreign Exchange Reserves*




*Excluding holdings of commercial banks

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