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ECONOMIC REFORMS IN SOUTH VIETNAM

by

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During 1970 and 1971 the government of South Vietnam introduced a number of far-reaching economic reforms involving interest rates, exchange and tariff rates, prices and land redistribution. These were aimed not only at stabilizing the economy and increasing governmental revenues, but also at preparing the country for a greater self-reliance in economic matters and creating conditions for economic development. The reforms were to a large degree inspired by the success of similar measures in South Korea and Taiwan, and their results to date seem to confirm the general validity of the approach which was tried in all three cases.

The Interest Rates Reform

One of the key elements in the reform program of the past two years has been the reform of the interest rate system. Its objective was to dampen inflation through increased absorption of money by the banking system, as well as to step up mobilization of domestic resources for development uses. With the annual rate of inflation in recent years in excess of 30 per cent (1), previously

(1) Saigon retail price index increased by 41 per cent in 1967, 34 per cent in 1968, 32 per cent in 1969 and 30 per cent in 1970. AID "Summary of Monthly Economic Data for Vietnam" November 1971, p.1.

existing interest rates provided highly negative rates of return on term deposits and Treasury bills, and windfall profits for those who had access to commercial credit.

The first step toward interest rate reform was taken in March 1970, when rates on savings deposits were raised from 4 to 5 per cent per annum and rates on most time deposits were raised 3 percentage points. (See Table I). Two months later, on May 1, 1971, interest rates on Treasury bills were substantially increased. Previously, the Treasury bill rates had ranged from 3 per cent to 6 per cent for bills with maturities ranging from 3 to 12 months. The rates adopted on May 1 ranged from 8 per cent to 12 per cent for bills with these maturities, and bills with 18-month and 24-month maturities were also introduced. They bore rates of 14 per cent and 18 per cent respectively.

While the new rates were substantially higher than any previously offered in Vietnam, they still represented a negative real rate of return, since prices were rising about 30 per cent a year. They were also less favorable than rates offered in the unorganized money market.

The interest rate changes did not produce as large a rise in savings as had been hoped for. In the year ending August 1970, time deposits and private sector holdings of treasury bills increased by VN$5.7 billion. This was equivalent to only a little more than one-fifth of the increase in money supply during the same period. This was not enough to slow down the inflation.

Accordingly, it was decided to push interest rates up still higher. On September 15, 1970, rates on savings deposits were doubled, from 5 per cent to 10 per cent. Time deposit rates were almost doubled, the new rates ranged from 11 per cent for one-month deposits to 20 per cent for 12-month deposits. Treasury bill rates remained unchanged for the time being. However, they were also raised substantially on March 1, 1971, with the new rates running from 12 per cent for 3-month bills to 22 per cent for 24-month bills. Lending rates were raised proportionately. A small additional upward adjustment was made in some of the rates on August 16, 1971.

Table I: The Structure of Interest Rates in South Vietnam

Annual rates effective on:	1969		1970			1971	
	June 1	Aug.1	Mar. 1	May 1	Sept.15	Mar. 1	Aug. 16
Savings Deposits		4%	5%		10%		12%
Time Deposits							
1 month		4	4		11		11
3 months		5	8		14		16
6 months		6	9		16		16
9 months		7	10		18		18
12 months		10	12		20		21
Treasury Bills							
3 months	3%			8%		12%	15%
6 months	4			9		14	17
9 months	5			10		16	18
12 months	6			12		18	20
18 months				14		20	21
24 months				18		22	22
Lending Rates							
Guaranteed loans		8	9		18		24
Non-guaranteed loans*		10	13.9		20		30

Source: Various issues of Bulletin Economique, Banque Nationale du Viet-Nam.

With the rate of inflation in 1971 dropping to a mere 2 per cent in the first 7 months and 14 per cent for the entire year, the real rate of interest on both term deposits and Treasury bills for the first time in recent years became positive. The results of this development have been quite obvious. In the 14 months between September 1970 and November 1971, total private sector savings increased by 175 per cent compared to a 62 per cent increase in the preceding 14 months. Time deposits increased by 49 per cent during the last 3 months of 1970 following the September 15 reform, compared to 33 per cent increase in the preceding 9 months, and continued to grow by another 121 per cent in the first 11 months of 1971 (See Table II).

Savings deposits increased by 105 per cent in the 14 months between September 1970 and November 1971, compared to a mere 12 per cent increase in the preceding 14 months. The volume of Treasury bills held by the private sector increased by 116 per cent during the 9 months between March and November 1971, compared to 59 per cent increase in the preceding 9 months (2). The increase in savings-type financial assets held by the private sector amounted to about VN$36 billion between the end of September 1970 and the end of November 1971. This was equal to more than 93 per cent of

(2) Ibid., p. 4.

the increase in money supply during the same period. This development was particularly significant as the increase in money supply in 1971 was considerably larger than in the preceding two years.

Foreign Exchange Reform

The government of South Vietnam raised the official exchange rate from VN$80 per U.S.$1 in June 1966, and at the same time added a VN$38 per U.S.$1 surtax on all financial and commercial transactions thus establishing an actual exchange rate of VN$118 per U.S.$1. This rate remained unchanged until October 1970. It was highly overvalued as early as October 1966, as indicated by the black-market rate of VN$171 per U.S.$1, and the degree of overvaluation rapidly increased in the following years. Following a 279 per cent increase in the Saigon retail price index between January 1966 and October 1970, the dollar rate in the black-market increased to VN$435 in October 1970, or by more than 157 per cent over the rate in January 1966. (see Table II).

The government attempted to reduce the degree of overvaluation by raising duties and various import taxes. For example, the "austerity tax", which at the end of 1969 was levied on 73 per cent of the current value of imports, raised the effective cost of imports to an average of about VN$250 per U.S.$1 (3). Even so, the effective

(3) IMF "21st Annual Report on Exchange Restrictions" 1970, p. 553.

Table II: Selected Economic Data VN$1 billion

	Money Stock	Savings Deposits	(r)	Time Deposits	(r)	Treasury Bills held by Priv.Sect.	(r)	Saigon Retail Price Index (1965=100)	Dollar Price in the Free Market
1969									
December	140.7	5.8	4%	8.0	10%	1.5		535	360
1970									
January	151.9	5.8		8.2		1.6		554	328
February	153.5	6.2		7.9		1.6		601	360
March	150.0	6.0	5%	8.4	12%	1.7	12%	579	418
April	148.8	6.0		9.0		1.7		618	413
May	148.7	6.0		9.5		1.8		633	377
June	149.0	5.9		9.9		1.9		662	382
July	151.7	6.0		10.0		2.2		684	382
August	156.3	6.0		9.5		2.5		670	415
September	152.6	6.2	10%	10.7	20%	2.6		684	426
October	152.3	6.3		12.4		2.6		686	435
November	156.1	6.6		14.4		2.6		715	395
December	162.9	7.2		15.9		2.7		697	388
1971									
January	180.0	7.7		17.7		2.8		718	394
February	179.2	8.5		20.1		2.9		700	399
March	178.3	8.9		21.4		3.2	18%	691	403
April	180.4	9.3		23.4		3.4		702	395
May	182.2	9.7		25.0		3.8		712	378
June	187.1	10.5		26.6		4.1		710	374
July	189.2	10.9		28.6		5.0		712	365
August	189.8	11.2	12%	30.8	21%	5.2	20%	738	350
September	188.6	11.8		33.4		5.5		757	366
October	187.5	12.3		35.1		5.9		760	365
November	191.4	12.5		35.4		6.2		768	425

(r) Interest rate per annum.
Source: AID "Summary of Montly Economic Data for Vietnam" November 1971

cost of imports still allowed those who had access to import licenses to reap windfall profits, which in turn induced widespread hoarding, speculation and corruption. Because the official accommodation rate for purchases of piasters for personal use by U.S. military and civilian personnel remained fixed at VN$118 per U.S.$1, such purchases were increasingly diverted to the black-market. This deprived the government of additional foreign exchange earnings and increased the flight of capital from Vietnam.

Piaster Devaluation of October 1970: The first major step towards reduction of the volume of imports and curbing hoarding and speculation was taken in August 1970 when the government raised the range of advance import deposits from 25-50 per cent to 100-500 per cent of the value of imported items. This measure also had the effect of increasing the absorption of money by the banking system. During the last 4 months of 1970, it immobilized VN$13.6 billion.(4). Advance import deposits were abolished in November 1971.

Even more significant was the introduction in October 1970 of a parallel market rate of VN$275 per U.S.$1, as compared to the official exchange rate of VN$118 per U.S.$1. The official rate continued to apply to governmental transfers, including the U.S. purchases of piasters for official purposes, selected imports and student expenditures. The new rate applied to exports, most imports, invisible transfers and the sale of piasters to U.S. personnel.

(4) National Bank of Vietnam "Annual Report, Fiscal Year 1970" p. 5.

A complementary "perequation tax" of VN$157 per U.S.$1 was at the same time applied to a number of imports financed with Vietnam's own foreign exchange and effected through the parallel exchange market. This further raised the effective exchange rate for such imports. In March 1971 the exchange rate for freight and P.L. 480 imports was shifted from VN$118 to VN$275 per U.S.$1.

The results of these measures were encouraging. Even though the new accommodation rate for U.S. personnel fell short of restoring the 1966 relationship (5), the conversion of dollars into piasters by U.S. personnel through the official channels increased from an average of $2.3 million during the six months prior to October 1970, to $7.6 million a month during the last three months of 1970. During the first 8 months of 1971 the average conversion rate was $3.2 million a month. The increase in the volume of conversions was particularly significant in the light of the reduction in the U.S. troop strength in Vietnam.

(5) With the Saigon retail price index increasing by 279 per cent between January 1966 and October 1970, and the U.S. price index increasing at the same time by 20 per cent, an accommodation rate of VN$375 to U.S.$1 was needed to restore the 1966 relationship between the two currencies. See: "Inequitable Currency Exchange Rates in Vietnam". Hearing before a Committee on Government Operations, House of Representatives, 92nd Congress, July 8 and 9, 1971, U.S. Government Printing Office, 1971, p. 14.

The reforms' success was also reflected in the decline of the black-market rate of dollar since October 1970. From the peak of VN$435 per U.S.$1 at the end of October 1970 the rate steadily declined to VN$350 per U.S.$1 by August 1971, the lowest level in 19 months. By the end of October 1971, the rate again increased to VN$365 which, however, was still considerably below the rate a year earlier. The decline in the dollar black-market rate was in part due to a tighter liquidity situation resulting from the money absorption by the banking system and by the advance import deposits.

An important related measure, a more open import licensing procedure, was also introduced as a part of the October 1970 reform package. Not only was the list of completely restricted imports significantly reduced, but the access to import licenses was made open to the general public. This was aimed at breaking up the monopoly of the established importers and at reducing hoarding and speculation. The government has demonstrated its intention to replace the system of direct and detailed controls, restrictions and subsidies with a more market-oriented system. Based on more realistic exchange rates, such a system should require fewer quantitative controls and be more conducive to export expansion and the attraction of foreign investment. It should also reduce imports and dependence upon foreign aid.

<u>Reforms of November 16, 1971</u>: Preparation of the ground for this transition was one of the principal objectives of the further devaluation of the Vietnamese piaster on November 16, 1971. The latest reform established four basic exchange rates:

> VN$118 per U.S.$1 continues to be the official parity rate, but it applies only to governmental transfers and student expenditures;
>
> VN$275 per U.S.$1 applies to all U.S.-financed imports under the P.L. 480 and Commodity Import Program (CIP);
>
> VN$400 per U.S.$1 applies to imports financed by Vietnam's own foreign exchange, as well as by foreign credit;
>
> VN$410 per U.S.$1, "financial rate," applies to the exports and invisible transfers.

Although U.S.-financed imports come under the still substantially overvalued exchange rate of VN$275 per U.S.$1, the actual landed cost of these imports is almost equal to the cost of imports under the VN$400 rate, because generally only U.S. commodities can be purchased with aid funds, and they tend to be higher priced than goods from other sources.

An important feature of the new exchange system is its promised flexibility. All three rates, other than VN$118, are supposed to be frequently adjusted commensurate with the rate of inflation. The Vietnamese want to avoid becoming committed to one rate as in the past. It is hoped that the combination of realistic exchange and interest rates will make it attractive to hold funds in Vietnam. The amount of invisible transfers that can be legally channeled through the open market will be limited, which should also help to check the flight of capital. Purchases of foreign exchange by importers, however, will no longer be rationed, and the list of goods prohibited for importation is being drastically reduced.

The move to liberalize imports is justified by the apparent realism of the new exchange rates in the legal currency market as indicated by the reduction in the spread between them and the black-market rate. With rumors of impending devaluation, the black-market price of the dollar moved up from a low of VN$350 at the end of August to VN$427 on November 15, and then to VN$446 on November 22. It has declined since then, stabilizing by mid-December at a level of VN$410 which is commensurate with the "financial" rate for currency conversions by individuals in the legal market. Although substantially reduced in size, the currency black-market is unlikely to disappear altogether. For one thing, the U.S. contractors are still required to purchase piasters at the highly overvalued rate of VN$118 per U.S.$1.

An increase in the cost of imports due to the devaluation will be offset to some extent by a major reduction in import taxes under a new tariff schedule which was also introduced on November 16, 1971. Until the new schedule is approved by the Vietnamese parliament, tax reduction will be carried out through governmental subsidies to importers. The new tariff schedule contains only four basic rates ranging from zero to 200 per cent. These are to be applied to the c.i.f. cost of the goods at the applicable exchange rate. The previous schedule with the multiplicity of rates and schedules was too complex. The new measure makes it easier to collect and adjust duties, which should reduce tax evasion and increase revenues from import duties.

An important part of the reform program in the past two years has also been an increase in the prices of imported commodities distributed through governmental channels. Official prices of rice and sugar were raised by 50 per cent in October 1970. As a part of the reform package of March 1971, the price of imported rice was raised further so as to equal the prices of equivalent local varieties. Sugar, cement and wheat flour prices were also raised. Simultaneously, state subsidies to public enterprises, including those jointly-owned with private interests, were drastically reduced. These measures were designed to increase governmental revenues, reduce expenditures, and provide an additional stimulus to domestic production. Together with the reform of interest rates and foreign exchange rates, this represents a step toward establishing a more open economic system.

Anti-Inflationary Effect

The reform program has had a rather dramatic anti-inflationary impact. The Saigon retail price index remained stable during the first 6 months of 1971. At the end of June 1971 the index for all items was less than one per cent above the level at the end of December 1970 (6).

(6) In contrast, the retail price index for the first half of the year increased by 24 per cent in 1967, 26 per cent in 1968, 8 per cent in 1969 and 25 per cent in 1970. AID "Summary of Montly Economic Data for Vietnam" p. 1.

The index moved up, however, in the second half of 1971, reaching by the end of December the level 14 per cent above the one a year ago. This reflected price increases caused by the November devaluation. Even so, the annual rate of inflation in 1971 compared most favorably with the 41 per cent rate in 1967, 34 per cent in 1968, 32 per cent in 1969 and 30 per cent in 1970.

The sharp decline in the rate of increase in retail prices in 1971 is an interesting development considering the fact that prices of imported goods and the wholesale price index increased during the year almost as fast as in 1970, and that the money supply increased by a much larger amount than in the preceding two years. Despite the sharp increase in the money absorption by the banking system, the money supply increased in the 10 months of 1971 by 17.5 per cent compared to 10.5 per cent increase in the same period of 1970 and 11.6 per cent increase in 1969. (7). The potential inflationary effect of this acceleration in the growth of money supply in 1971 was increased by the 2 percentage points decline in the rate of growth of domestic industrial and agricultural production compared to 1970.

One of the reasons why this potential did not fully materialize was the $40.7 million increase in imports during the first 10 months of 1971. This increase was a net result of the

(7) Ibid., p. 4.

$62 million increase in imports of consumer and industrial manufactured goods, as well as the smaller increase in imports of industrial raw materials and semi-manufactures, and the $31.7 million drop in food imports. In fact, it was the rise of food, especially rice, prices which was primarily responsible for the increased inflationary pressures in the second half of 1971.

The reduction of food imports in 1971 followed a substantial increase in domestic agricultural production. Rice imports were stopped altogether in April 1971 and not resumed until November. The reason was the prediction by government officials earlier in the year that rice self-sufficiency would be achieved with the 1971-72 crop. Self-sufficiency in rice and other foods, however, is only partially a production problem. It is equally a problem of moving foodstuffs from the surplus regions in the Mekong Delta to the deficit regions in the North. It was largely for this reason that the projected self-sufficiency failed to materialize. As government stockpiles in the Northern provinces were rapidly depleted, speculation and hoarding sharply increased, pushing rice prices up. If it was not for this apparent miscalculation, the rate of inflation in 1971 would probably have been lower than it actually turned out to be.

However, increased imports were only partially responsible for the slow-down in inflation. A more important reason was the substantial drop in speculation and hoarding. Doubling of the commercial lending rates between March 1970 and August 1971 and the increase in the cost of imports due to the exchange rate reform have greatly increased the cost of hoarding. At the same time, opening up of the commercial credit and import licenses to the general public has weakened the monopoly hold of the established traders on the commodity markets, increased competition and reduced the pressure on consumer prices. The highly divergent movement of the wholesale and retail price indexes in 1971, as shown in Table III, reflects the narrowing spread between wholesale and retail prices due to the combined effect of the increased cost of hoarding and of the reduced profit mark-ups.

Table II: Increases in Wholesale and Retail Price Indexes, first 10 months

	Wholesale Price Index (1966=100)		Retail Price Index (1965=100)	
	General	Manufactured Products	All items	Non-Food Products
1969	29%	18%	23%	13%
1970	16%	29%	28%	26%
1971	14%	17%	9%	6%

Sources: Data for Wholesale Price Index, various issues of Bulletin Economique; data for Retail Price Index, AID "Summary of Monthly Economic Data for Vietnam" November 1971, p. 1.

The reforms have also helped to increase government revenues. More than VN$149 billion of revenues from Vietnam's own sources (8) were collected during the first 10 months of 1971. This represented an almost 48 per cent increase over the same period of 1970. In nominal terms this growth rate was only marginally above the rates achieved in the preceding years. However, when deflated by the 9 per cent increase in retail price index during the same 10 months of 1971, the resulting 39 per cent increase in revenue in real terms compares very favorably with the similarly deflated annual rate of +4% in 1967, -16% in 1968, +37% in 1969 and +20% in 1970. (9).

Even so, the rate of expansion of government borrowing from the banking system to finance the budgetary deficit increased in 1971. During the first 10 months of 1971, the net claims of the National Bank of Vietnam on the public sector went up by 25.1 per cent, reaching VN$225.4 billion, compared to 23.2 per cent increase in the same period of 1970 and 21.3 per cent in 1969 (10). However, considering the fact that in 1971 the Vietnamese had to assume a much greater burden of war prosecution, so marginal an acceleration in deficit financing can be viewed as an accomplishment in itself.

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(8) Revenue from own sources, as distinguished from the local currency funds made available to the Government of Vietnam by the U.S. authorities, in recent years accounted for about 80 per cent of the Total National Revenue.
(9) AID "Summary of Monthly Economic Data" p.9.
(10) Banque Nationale du Viet-Nam, Bulletin Economique, various issues.

Significantly, commercial banks' claims on the private sector jumped by 42.1 per cent during the first 10 months of 1971, which represented a major acceleration from the 18.4 per cent increase in the same period of 1970 and 8.8 per cent in 1969 (11).

Prospects for Economic Development

The economic reforms of 1970 and 1971 came at a time when the focus of economic policies in South Vietnam has been increasingly shifting from stabilization to promotion of economic development and long range planning. The improved economic situation in the past two years and an accelerated U.S. withdrawal have both permitted and necessitated this change. Of particular importance has been the improvement in agriculture, the sector which employs more than 60 per cent of the total labor force and contributes close to 40 per cent of GNP. Following a sharp decline between 1965 and 1968, agricultural production increased by 12 per cent in 1969, 9 per cent in 1970 and probably by 7 or 8 per cent in 1971. In 1971 rice production has almost regained the record level of 1963 when South Vietnam was a rice exporter.

The growth of agricultural production so far has been largely the result of improved efficiency, thanks to the increased security and the introduction of miracle rice, rather than to any large new capital investment. Further expansion and diversification of agricultural production, however, would increasingly depend upon

(11) Ibid.

new investments and the introduction of new production methods. An ambitious <u>land reform</u> program launched in March 1970 is expected to facilitate these improvements. Its objective is to distribute without charge more than 2.5 million acres of cultivated land, which represents about half of the total rice acreage, to some 800,000 tenant farmers by the end of 1973. The U.S. government is contributing $40 million through CIP imports to help to meet the cost of the program. Former landlords will be eventually compensated for the expropriated land in the form of cash and bonds. More than half of the land had been already distributed by November 1971. So far, however, the economic effects of the land reform have been less significant than its political implications.

Because of manufacturing industries in South Vietnam were located in secure areas, the growth of industrial production has not been frustrated by military factors. In fact, industrial production increased 55 per cent between 1965 and 1970, or at an average annual rate of 9.1 per cent. The growth has been especially rapid in power generation, textiles and in some new industries like cement, plastics, electrical equipment and lumber processing. It has been prompted mainly by the increased demand from the military, by rapid urbanization, but especially by the massive inflow of U.S. assistance which provided not only foodstuffs and other consumer items, but also equipment and raw materials for manufacturing industries.

Although South Vietnam has acquired some new industries, a rather well developed infrastructure and a substantial pool of trained labor, industrialization is still in its initial stages. Its future progress will depend upon an increased inflow of foreign capital equipment and materials. The outlook for such an increase, however, is clouded by the sharp reductions in foreign exchange receipts that are now threatened.

As the war progressed, Vietnam's exports declined from \$88.8 million in 1960 to only \$12.8 million in 1970, while imports jumped from \$321 million in 1963 to \$850 million in 1970. About half of the resulting trade deficit has been financed by the U.S. aid, the other half by dollar receipts from the sale of piasters to U.S. forces. Net service earnings were close to \$300 million annually during the past three years.

With the accelerating withdrawal of U.S. forces, however, this source of foreign exchange receipts will soon dry up. The larger earnings of dollars from the sale of piasters for use by U.S. personnel after introduction of a more realistic accommodation rate is an improvement of a very temporary nature. It appears doubtful at the moment that the U.S. bilateral aid can be substantially increased. However, there is some hope that, with further Vietnamization, other nations and international lending institutions would be more willing to provide economic assistance to Vietnam. The country has the potential for effective utilization of such aid.

Notwithstanding this latter possibility, it is most imperative for Vietnam to cut imports and expand its export earnings. It is only too obvious that, with U.S. withdrawal, the country would not be able to maintain imports of foodstuffs and consumer manufactures at the level of recent years, when such imports accounted for more than 40 per cent of total import bill. It is to be hoped that the domestic production of foodstuffs and consumer goods will expand rapidly enough in the next few years to forestall any drastic decline in the standard of living of the average Vietnamese. Vietnam might well learn from the experience of Korea, which had to cut imports from the peak 1957-58 level as U.S. aid was reduced. Korea eventually found that creation of conditions that encouraged exports and attracted private capital was a far better basis for economic growth than dependence on foreign assistance.

Unless security again deteriorates, production of rubber, which is traditionally Vietnam's most important export commodity, can be significantly increased. In a year or two, rice may again become a surplus commodity. Future world demand for these commodities, however, is quite uncertain at the moment. Export expansion, therefore, should come primarily through the development of new export industries, and this would require a large inflow of private foreign investments as well as a stepped-up rate of domestic investments.

Although the economic reforms of the past two years have helped to create better conditions for such investments, much remains to be done. To hold the line against inflation the government would have to reduce deficit financing substantially. This will be a very difficult task indeed, unless the loss of revenues generated by the presence of U.S. troops can be replaced by increases in revenues from Vietnam's own sources.

A meaningful tax reform can be of considerable help in this respect. The need for such a reform has been recognized for some time. An ambitious 10-point tax bill was introduced in the National Assembly in December 1969, but later was dropped. No new tax provisions were included in any of the reform packages in the past two years. Instead, the government has expanded the practice of granting tax concessions to various groups of the population. Despite recent improvements, there still remains an urgent need to further simplify cumbersome bureaucratic procedures and to reduce governmental controls over domestic and foreign investments.

The November reforms signal an important change in attitude and a realization of the need to build a basis for self-sustaining growth. The reforms that remain to be accomplished will come if political stability can be maintained and the leadership continues in its resolve to build on the basis of a market-oriented economy.