CHAPTER 2 ECONOMIC POLICIES FOR GROWTH

INTRODUCTION

The economic development of Vietnam will require not only careful planning but the application of economic policies that directly stimulate growth through public action or establish an environment in which private initiative can operate effectively. There is no single best set of policies to accomplish the objectives, for these policies must also change to meet changing conditions. These pose difficult problems even for the experts, and there may be disagreements from time to time as to the best actions to take to meet a specific situation. We are not primarily concerned with this range of policy problems because we are not trying to predict the exact course of events in the post-war period, though it is inevitable in this chapter, and the succeeding ones on monetary and fiscal policies, that some of the alternative situations and the actions required to meet them are discussed. Such economic discussions of the issues are meant to illuminate the range of choices that are likely to be open.

There is another sense in which policy choices and alternatives are important; that is, the way such choices reflect the kind of political environment in which development occurs, whether, for example, through central government control the majority of resources are channeled to productive use or, alternatively, whether the private sector will have a significant role in such decisions. The choices finally made in these and similar matters together make up a large part of the strategy of development that will be followed in the post-war period*.

* See Economic Policies in the Transition to Peace and After, Joint Development Group, Working Paper No. 23, June, 1968.

INVESTMENT PRIORITIES IN AGRICULTURE AND INDUSTRY

Vietnam is now and will continue for some time to be primarily an agricultural country. Agricultural pursuits contribute the largest single share of the gross national product and involve a large majority of the population. This will not change appreciably in the decade after the war, for although relative rates of growth are likely to be somewhat different, with an industrial growth rate of 7% possible in contrast to 5% or less in agriculture, the shares of the two sectors will change very slowly.

It is often said that for development to occur, the agricultural sector must supply the labor for industry to expand, and since traditionally there is under-employment in agriculture, this transfer of labor should not adversely affect production of agricultural products nor cause food prices to rise. This way of looking at the problem causes no concern to Vietnam. Although there is every reason to believe that a vigorous development effort in industry will be forthcoming (as described in Chapter 9), the additional amounts of labor and agricultural raw materials required for the industrial expansion will be readily available. Demands within agriculture create no constraints on industrial development in Vietnam. Quite the contrary, the developments in the two sectors are complementary, and if they are not necessarily to be kept at the same pace, they should not, at least, become widely disparate in their rates of growth.

As a practical matter most countries have ignored agricultural development at their peril, and have later found it most difficult to make up lost ground and to attain a satisfactory rate of agricultural growth. Total growth of an economy is far more likely to be held back by lagging agriculture than by lagging industry. That is most certainly the case for Vietnam since the level of agricultural output achieved will in part determine the amount of imports required, and, most importantly, the amount of exports and foreign exchange that are available.

Sometimes the matter is stated in terms of competition between the two sectors for limited investment (or agriculture *versus* industry), and typically the analysis shows that investment in industry should be preferred and brings greater benefits to the economy. The argument is sometimes based on a generally lower capital-output ratio in investment, so that one unit of investment in industry contributes a larger amount directly to the national product than a similar unit in agriculture. Sometimes the argument is based on a desire to cut down on industrial imports through import substitution (a topic that is examined later in this chapter), and sometimes there is simply an unreasoned preference for development of industry because that creates the image of a modern economy.

We believe that these are not useful ways to pose the problem of priorities in development between industry and agriculture. Choices of projects always have to be made, of course, after an evaluation of their costs and benefits, but an argument that attempts to show that investment in industry is, as a general matter, superior to investment in agriculture is clearly faulty and is arrived at only by focusing on some facts and ignoring others. But one thing is clear: Vietnam, for reasons that are amply described in various places in this report, must undertake a deliberate program to strengthen and stimulate the growth of agriculture. Complementary investment in industry, both to supply products that are needed in agricultural production and those desired for consumption by farmers with rising incomes, will most surely grow and, as we have observed above, at a rate of growth above that for agriculture. A determination of the best pace for investment in both sectors will emerge from later detailed project analyses, but an economic policy of growth for Vietnam that gives first place to industry is surely in error.

THE ROLES OF THE PUBLIC SECTOR AND THE PRIVATE SECTOR

If Vietnam is to develop at a satisfactory pace, the energies of both the public sector and the private sector are needed to complement and strengthen each other in undertaking productive investment, in marketing products, and in carrying on the many commercial activities of a growing economy. The roles of the two probably will not be equal, even assuming that equality is somehow measureable, but the complete dominance of the public sector that is found in centrally-directed economies is not appropriate for Vietnam in the future and, indeed, it would represent a change from current conditions.

The majority of fixed investment in the country in recent years has originated in the private sector. The public sector has contributed less than 20% of new fixed investment, but this is an unnaturally low figure due to the high level of current operating costs of the war. In many other developing countries, under normal conditions, public investment typically ranges between 40% and 60% of the total. The exact figure at any one time depends on the vitality of the private sector and its evaluation of risks and rewards, and on the ability of the Government to obtain savings from the budget. In the post-war period the share of total investment attributable to the public sector will almost surely rise, and must do so if the many needs of social infrastructure are to be met.

The responsibilities for development assumed by the public sector and those retained by the private sector divide roughly along traditional lines. Investment responsibility for roads, schools, health and sanitation, and possibly areas in housing, is clearly in the hands of the Government. In Vietnam the provision of electric power, and particularly rural electrification, is unlikely to be sufficient without direct Government investment, though private technical assistance in operations during an interim period will improve efficiency. The sectors of manufacturing, commerce, trade, and finance are in general the ones that should be left to the private sector. Investment in these sectors has in the past primarily originated in the private sector with perhaps a few specific exceptions such as textiles. There are, however, three important points to note about future private investment in these sectors, which should be among the fastest growing ones in the economy. First, in some specific cases mixed public and private ventures are very likely to be more successful than either public or private alone. One such case is fertilizer production, which is discussed in Chapter 9 on Industrial Development. There may well be other cases where mixed ventures are preferable, possibly in instances of very large-scale investment. Such ventures have worked well in other countries. Second, the public sector in Vietnam has made substantial investment in manufacturing industry and is taking steps to divest itself of such investments and return these activities back to the private sector. It is entirely appropriate that this be done, since these investments have in the past shown consistent losses. It is hoped that the process of divestment can be achieved soon. The valuation of assets of these companies may, however, pose some difficulties. Unfortunately the depreciated historical cost of the assets is not the proper base for market valuation. These companies only have a value to a private investor based on their present and future projected profitability, that is, their value as "going concerns" and it may be necessary simply to write off as a loss part of the asset costs in order to dispose of them. The U.S. has had exactly this experience with plants built with public funds during World War II, and ultimately sold them at a fraction of historical cost.

Third, and most importantly, the private sector will fulfill its role of generating growth in productive investment providing it has freedom from unnecessary controls and regulations in starting a risky venture and carrying it through. On this point the present situation must be reformed to create the correct kind of competitive environment, particularly in allowing freedom of action to meet market demands as an entrepreneur sees them. The competitive market is one of the most efficient instruments for achieving the best use of men and money in the interests of all of the people. Yet at present, perhaps as a result of war demands and the need to control inflation, new private investment is subject to many controls, starting with application of approval of the project in principle, and extending to an evaluation of the use of equipment and materials, approval of construction and imports, and later regulation of management of the plant. In a wartime environment strict controls to conserve foreign exchange and prevent speculative short-run profits are justified, but if development is to occur, many of these controls and regulations on private business must be removed. They were originally imposed because of the war and their raison d'etre will cease with the end of the war. It is easy to fall into the habit of piling control upon control, often ill-designed to promote either economic efficiency or social equity, and with near-disastrous effects on the economy. There are more examples of such controls than can be listed in this report, but a major requirement after the war is for a commercial and incorporation code that establishes the right of the investor in a business to manage and conduct his affairs as he will, subject to general regulations ensuring that this does not lead to monopoly or economic power that is used against the public interest.

The public sector has the primary responsibility for guiding the economy along paths of development and for guaranteeing that the benefits are spread to the people. It has an impressive arsenal of policy instruments to accomplish these objectives. Through tax policy and public welfare programs it meets the requirement for equity in sharing burdens and benefits of development. Through monetary and fiscal policy it controls the availability of credit, guides investment, and provides the capital needed in infrastructure. It has additional controls over trade and other activities. With these instruments at its command, the public sector should require only minimal direct controls and restrictions on private business.

In speaking of the private sector it should be noted that a significant part of that sector is made up of Vietnamese of Chinese descent. The business activities of this group are extensive and in some instances possibly even dominant. They account for a large part of the conduct and financing of import trade, and the marketing and processing of agricultural products, and are active in many lines of trade and commerce. These activities contribute a great deal to the successful functioning of the economy now, and they are essential to development in the future; therefore, the participation of this group in development and their contribution to the growth of Vietnam should be as welcome as the contribution of all other citizens. In fact, they should be expected to perform in this way. Special controls on or discrimination against this group are not only unnecessary but actually are against the best interests of the country. On the other hand, if there are activities of the group that lead to the formation of monopoly power in lines of business or that result in the exercise of economic power contrary to the development goals of the country (for example the export of capital), such activities should be penalized and controlled to the same extent as for all other groups in the society. If this course of action is followed, the greatest benefit to the country will occur, and economic activities from whatever source will be judged by how well they contribute to economic growth.

We cannot in this report consider every case in detail where the public sector and the private sector meet and divide responsibility. What has been done is to outline the basis for an <u>open economy</u> - one that can take advantage of individual initiative as well as group action for the benefit of the whole country. This general policy will lead to the most rapid and efficient development of resources, and equitable distribution of the benefits of growth. Additional aspects of this economic policy are discussed in this chapter and in succeeding chapters.

EXPORT PROMOTION AND IMPORT SUBSTITUTION

Vietnam cannot increase its per capita income above the rate of population growth by concentrating solely on the development of industries and agriculture to serve the domestic market from its own resources. This is true for several reasons, one being that the resources of Vietnam are not diversified enough to supply the variety of goods that are wanted. There is a technical or natural resource limitation. But also to develop local industry and agriculture at all normally requires capital goods that are not produced locally and must be imported. Moreover, as incomes rise, there is an increased demand for consumer goods of wide variety and the growth of more complex local industries again raises the demand for imported capital goods. The spiral does not continue indefinitely since some balance is reached between local production and imports, but for a country in the early stages of development, such as Vietnam, the process described is quite typical. As local industry and agriculture grow, imports will also grow, and to earn the foreign exchange necessary to pay for the imports of consumer goods and capital goods, exports of products, supplemented by inflows of capital funds, are needed.

The range of problems suggested by this simple description is great, and the problems themselves are complex. What is the relationship between the potential growth of gross national product and the level of imports and exports? Can a country grow as satisfactorily with imports and exports at 5% to 10% of GNP as at 15% to 20%? What are the opportunities and the limits on substituting local production for imports as a strategy of development? What are the potentials for the growth of exports in Vietnam in the future? If imports and exports grow at different rates, how will internal growth be affected and what are the needs for external assistance to meet a balance of payments deficit?

Can Vietnam achieve self-sustaining growth without the injection of large inflows of capital? These are just a few of the perplexing problems that must be somehow solved in preparing a development plan. Only a complete model of the economy will permit consistent answers to the questions, for the growth of output and income, the level of investment, exports, imports, and other variables are interrelated. We do not yet have such a model, but for some key issues a rough but practical guide to future needs can be outlined.

A policy of import substitution has appealed to many countries, often to their later regret. As a general rule the domestic market should be large enough to support at least one plant of efficient size, that is, one that can produce at costs competitive with import prices. If such a rule is not adopted, the economy is likely to end up with many small units producing inferior products at high costs. Such units invariably need permanent protection from competition from imported goods; tariffs and other taxes must be maintained at high rates, and the consumers must continue to pay relatively high prices for goods. Such high prices dampen demand while fostering continuing production for a smaller market. Resources are not used as efficiently as they could be and ultimately this seriously impairs the ability of the country to grow.

An emphasis on import substitution as a means to growth is usually linked to the desire to industrialize the economy. Many countries fear that they will simply become exporters of raw materials and agricultural products and will have to import industrial products and capital goods. Industrial development is somehow regarded as more favorable than agricultural development, and is considered the mark of a developing country. Moreover, reliance on agricultural and raw material exports as a source of foreign exchange to finance development is regarded as risky in the extreme. The alternative is to stress industrialization and import substitution rather than the development of exports, and thus to try to grow with a lower level of foreign trade. The several elements of this argument, which may sound attractive as a course of action for Vietnam, are worth examining closely.

The lack of confidence in agricultural exports as a source of foreign exchange is based on several notions: 1) the terms of trade inevitably move against agriculture; 2) the demand for such products is apt to be weak or uncertain because of competition from other sources; 3) a country that relies on exports of a few major products to a few markets is highly vulnerable because prices of the products may suddenly drop and reduce foreign exchange earnings drastically. Each of these notions may be true at times, but not necessarily for Vietnam or not necessarily to a significant degree, if certain steps are taken in the post-war period.

It has not been demonstrated that the terms of trade (that is, the ratio of export prices to import prices) inevitably move against exporters of agricultural and raw material products. The historical evidence is ambiguous; the results depend on the period of time chosen and the composition of the indices used. For some raw materials and agricultural products, prices have held up well and may increase as industrial demands and output grow. The import price index for Vietnam in the past six years has risen only about the same amount as the implicit GNP deflator, although the composition of imports is in general weighted with goods that have more volatile prices than the kinds of capital goods that normally account for a large fraction of imports in developing countries.

Many of the arguments presented on the inability of agricultural and raw material exports to support development have been based on Latin American experience with coffee and sugar, whose markets and prices have deteriorated rapidly in the past and are relatively weak today. It is true that in more normal times Vietnam has secured almost 90% of its export earnings from rubber and rice. Rubber has suffered competitively from synthetic rubber, but it has been estimated that the world market demand for natural rubber will continue to grow, though at a lower rate than for synthetics. Nevertheless, if Vietnam had to rely in the future on these two exports alone, the outlook would be bleak. Specialization on a few export crops does have risks; many underdeveloped countries do in fact have a high concentration of exports in a few products such as coffee, sugar, bananas, tea, rubber and cocoa. The prices of these products have often fluctuated widely and in some cases overproduction has depressed prices badly. This might happen with rubber, and in a longer period with rice, but as is discussed below, Vietnam can diversify exports to avoid the risks of over-dependence on a few crops. The opportunities for diversification include both a larger number of agricultural products and raw materials and a sharp increase in exports of processed goods and manufactured products. This degree of diversification should greatly reduce the vulnerability of Vietnam to sudden fluctuations of prices of a few products or to the deterioration of conditions in a few markets.

Because Vietnam is, relatively, a small country, it will not have a large share of the total export market in any major product, but it may in fact have a share in a regional market for some products large enough for changes in the volume of Vietnam's exports to have an effect on prices and market conditions. In those cases it is important to manage the marketing of the product so as to obtain the best possible terms of sale; in most cases, however, Vietnam will simply meet a world market price, and must adjust costs to be competitive.

The substitution of domestic production for imports is applicable in Vietnam, and may gain strength as development occurs, but it is not a course of action to be pursued in haste, since more often than not it leads to over-protection of domestic industry. There is already evidence of investment taking place in uneconomic facilities in metals and synthetic fibers; such investment would not occur without tariff and customs protection which permits the local producers to operate successfully at high production costs. There is no real reason now to search frantically for real opportunities for efficient import substitution. Chapter 9 on Industrial Development discusses in some detail a list of industrial plants and products that should be profitable investments primarily to serve the domestic market. Most of these would produce goods that are imported now or that would probably be imported in increased volumes after the war. The unfolding of these investment opportunities will reveal many instances of import substitution. We are not yet ready to provide quantitative measurements of the extent and pace at which this could occur within ten years after the war, but some rough idea may be obtained by considering the major categories of imports in 1966. In that year seven commodity groups accounted for just under half of total import licenses. These were: rice, motorcycles (two- and three-wheeled, including parts), textile fabrics, iron and steel products, petroleum products, chemicals (fertilizers and other), and trucks and buses (including parts). The import volumes of at least three of these groups were significantly inflated by war-related needs and might decrease (relatively) in a peacetime development period. These are: iron and steel; petroleum products; and trucks and buses. Plans are in existence for a petroleum refinery in Vietnam to operate on imported crude oil. That would have the effect of retaining the value added in refining in the country.

Several other commodity groups of imports might easily be replaced, at least in part, by domestic production. It is expected that in no more than two years after the end of the war, rice production could provide all domestic requirements and yield an exportable surplus. Vietnam can move rapidly into the assembly of motorcycles, with successively increasing domestic production of parts of the vehicle. This type of program has been successful in the automobile industry in several Latin American countries. It should be far simpler to implement efficiently with motorcycles than with automobiles. Chemical fertilizers are also included in the near-term development plan for local production.

Although the full details of import substitution cannot as yet be described, it is evident that there are opportunities in a range of commodities and products. Probably only in three major industry groups is it likely that substitution of domestic production for imports would be unwise and inefficient, at least in the near-term: basic metals processing and finishing; many chemical groups; heavy machinery and capital goods. These, however, contain many items required for investment in development. For these there is no substitute for imports; but in other areas import substitution should move forward as rapidly as cost comparisons will permit, because, for a given level of exports, a decrease in imports is equivalent to a decrease in the amount of capital that must be borrowed abroad.

The development of exports and export markets should have the highest priority in the post-war period. In the chapter on Industrial Development, several important projects are discussed whose primary objective is to earn foreign exchange. The prospects are bright, not only for these projects, but also for the expansion of exports as a whole. Nevertheless, to translate prospects into realities will take a concentrated effort.

It is unrealistic to try to project detailed export potentials, because so many uncertainties exist that affect such figures. Studies of specific world markets and the technical and economic feasibility of producing various products are required in order to have confidence in details. But it is important to have some notion of the possible range of exports. The analytical work we have undertaken so far provides a basis for the order-of-magnitude estimates shown in the Table below. These are estimates that might be achieved with ten years. The totals indicate a wide range in the possibilities, with the high figure almost three times the low one.

Table 2.1

Annual Export Potential

(US $ millions - 1967 prices)

Commodity Group	Low Estimate	High Estimate
1. Rubber	40	60
2. Rice	40	90
3. Fish products	10	40
4. Other agricultural products (cinnamon, vegetables, animal feeds, tea, etc.)	20	80
5. Industrial	50	170
	160	440

What can be said about these figures? Rubber and rice together in the past accounted for about 90% of total exports but are projected at a much lower percentage in the future because of diversification, particularly in industrial products. It is said that the rubber industry can be brought back to its former peak production and that good planting stock is available. In the chapter on Agriculture it is estimated that within ten years 1.5 million tons of rice can be available for export, and the figures on industrial products include pulp, plywood and wood products, and a variety of other products. Fresh and, more importantly, processed fish products could be the real surprise in exports, but it will take substantial investment in processing facilities and a great deal of technical assistance and training to achieve the result. Indeed, the levels of investment, market development, and training needed to reach the high estimate of almost half a billion dollars annually in exports may be beyond the capabilities of the economy even in ten years; yet, without the most intense effort to expand exports, economic growth may falter or become unduly dependent on external aid, thus delaying the time when the economy can sustain its own growth.

The low and the high estimates can be related to past peak export performance in order to show what is involved. The peak was about US $80 millions in the early 1960's, so that our low estimate is twice as high and the high estimate almost six times as high as the previous peak. But there was no real effort made to expand exports in those days. The experience of a few entrepreneurs in developing exports in the last few years and in the midst of war is evidence of what might be accomplished.

In any case Vietnam cannot grow steadily if it neglects foreign trade. A policy that turns toward autarchy and internal development alone will surely fail. The issues of growth and eventual economic independence hang in the balance.

EXTERNAL AID AND ECONOMIC INDEPENDENCE

The effort necessary to expand exports to earn foreign exchange and to substitute local production for imports to conserve foreign exchange raises the question of the size of the foreign trade sector in Vietnam's future, and also raises the question of external aid requirements to ease the transition to self-sustained growth.

Obviously no country can let a deficit in its balance of payments continue to grow without serious consequences. There is less strain if a country can grow with imports and exports at, say, 10% of the gross national product annually, than if the figure is 20% or higher. Is it possible to grow with low exports and imports, since a figure of 10% of GNP in exports probably could be readily managed by Vietnam in the next decade? The answer is that large, developed countries with many resources can have ratios of foreign trade to GNP as low as 10% or less and grow successfully. While there is no rigid relationship between the ratio of foreign trade to GNP and the growth of GNP, the probability of an underdeveloped country, such as Vietnam, growing at a satisfactory rate with both imports and exports around 10% of GNP is highly unlikely. The following Table shows the average ratio of imports or exports to GNP and the growth rate of GNP in the early 1960's.

Table 2.2

Country	Average Ratio of Exports or Imports to GNP	Average Rate of Growth of GNP
1. Malaysia	35 - 40	5 - 6
2. Philippines	15 - 18	4 - 5
3. Taiwan	17 - 20	8 - 9
4. Thailand	16 - 22	7 - 8
5. Burma	10 - 13	0 - 2

Malaysia has a significantly higher ratio than the next three (Philippines, Taiwan, Thailand) and Burma a lower one. Although there are variations in the growth rate, the first four countries are doing reasonably well. Burma is not, and, although its troubles are not solely due to a rather low foreign trade involvement, limitations on imports needed for local development have dampened the growth rate rather markedly.

Vietnam should not take either Malaysia or Burma as a model in this respect, for the former has unattainably high ratios (and may be more than normally vulnerable to market shifts), and the latter has not succeeded in financing the foreign exchange needed for a development effort. In both cases, of course, there are additional elements in the situation that go beyond the simple characterization presented here. It seems likely that Vietnam will compare, more closely, in its post-war programs, to the experience of the middle three countries who have foreign trade ratios roughly in the range of 15% to 20% of a growing GNP.

There will be differences between the early years of the period (the transition) and the later years. Exports cannot be expected to increase immediately and, in instances of large new plants, may be delayed from three to five years; meanwhile, imports will continue at a relatively high rate, because of reconstruction needs and as a counter-inflationary measure. With all of the uncertainties of the future it is perilous to make year-by-year estimates, but in aggregate figures it seems likely that the imports needed to sustain at least a 5% growth of the GNP will be about US $550-$650 million annually. In the past year or so import levels have been in this same range. Normally we would expect that these levels, which have been swollen by the war, would decrease rather substantially and still be sufficient for sustained growth, but as income rises in the decade, import demands will also rise, and by the end of the decade may be above the levels projected here. We cannot now assess the relative strength of this tendency to increase in comparison to the potential results of import substitution activities in terms of the net impact on import levels.

On a comparable basis exports are projected at about US $200 million in five years time, and hopefully rising to US $400-$500 by the end of the decade. As has been indicated previously, the performance of the export sector depends on the extent of the effort to develop such industries and products. The estimates made here are in the upper part of the range, and for that reason they indicate indirectly the consequences of lesser performance.

On this basis the trade gap would be about US $3 billion over the decade, but the greater part of it is likely to occur in the first five years, perhaps two-thirds of the total, with the remaining third in the second five years. The trade gap should decrease over the decade if the programs to expand exports and to limit imports are successful. In fact, if economic independence is to be achieved by the end of ten years, the balance of payments must not then be in a high deficit position requiring continued injections of foreign aid on concessionary terms. If the balance of trade shows a deficit, as it is projected to do even at the end of the period, the balance on services plus private capital inflows and a reasonable limit of suppliers' credits must be sufficient to bring the balance of payments into equilibrium.

It is believed that Vietnam might acquire foreign exchange through some services, particularly in tourism after the war. There will be curiosity on the part of people who have had sons, relatives, and friends serving in Vietnam, and if the natural attractions of places such as Dalat, Vung Tau, Nha Trang and many others can be advertised and good facilities provided, a vigorous tourist industry can be created.

The chapter on Industrial Investment identifies many profitable investments for private capital; some of them such as the pulp plant will require foreign investment and expertise. A rough tally of investments that might be attractive to foreign investors indicates that in the next ten years up to US $500 million in funds might be invested in the country. Some guarantees will have to be given to attract these funds, including guarantees against expropriation, against undue interference in managing the enterprise, and of permission to repatriate a major part of profits. Some limitations on repatriation are imposed by some countries and would be appropriate for Vietnam as well.

In spite of the best efforts to attract private foreign investment, or to build tourism or other services, about US $2.5 billion in concessionary foreign aid will be needed in the coming decade. This is a large amount certainly, but less annually than the average amounts supplied in recent years. It is hoped that this aid will be supplied at low interest rates and with maturities of at least 15 to 20 years. It is most essential that favorable terms exist, for if they do not, the debt service in interest charges and repayments will rise very rapidly. In fact Vietnam must be prepared for a rise in debt service burdens in any case. It has virtually no external debt now, which is fortunate, but that condition will not continue. We cannot now guess at the size or rate of increase of such burdens without knowing the terms of loans, but the experience of many other countries is extremely sobering. These burdens have often eaten up much of export earnings, have created or strengthened inflationary conditions in the country, and have led to a constant application to creditors to refinance existing debt. Vietnam should learn from this experience and do its utmost to avoid it, even at the cost of accepting a somewhat lower rate of growth.

Some countries have recently expressed a concern or an interest in the future financial needs of Vietnam for reconstruction and development. The United States has borne by far the largest burden in supplying aid, and a number of countries have benefitted greatly through supplying goods and services; for example, both Japan and Taiwan have exported substantial amounts in the last few years to Vietnam. With the end of the war and the start of a period of development, to expect a reverse flow, in some cases, is not unreasonable. In fact it might now be appropriate to open the topic of external assistance to wider discussion.

We suggest to the Government of Vietnam that steps be taken informally to determine the desirability of having a conference of countries to discuss all aspects of post-war development needs and aid requirements in the coming years. There are some indications that several countries might favor such a conference, and if one is arranged, the United States, Japan, Taiwan, the Philippines, Korea, Australia, and Western European countries should be invited to participate. Private banks and financial institutions in these countries might also have a definite interest in attending. Perhaps the Asian Development Bank, whose interests in development extend throughout this part of the world, might be willing to undertake the task of convening such an informal conference. We suggest that it be asked to do so. This could be one step in helping Vietnam to plot its course toward eventual economic independence in ten years.

DEVELOPMENT AND PRICE STABILITY

The inflationary problems that are of such great concern now will not disappear with the end of the war. While direct war expenditures will drop, many war-connected expenditures cannot be so readily decreased. Demobilization of troops will take time, and expenditures on the logistics base will have to continue. The transition is a critical period, but it now appears unlikely that a serious deflation will occur, particularly if development programs are initiated and phased in during this same period. Consequently inflationary pressures may well continue for a number of years.

Development with price stability is unlikely to be possible. In the chapter on Fiscal Policy it is shown that the demands made on the public investment budget will be great, and though Government revenues from taxes and other sources can rise , they will probably do so somewhat slowly. Also operating costs in the budget will be difficult to reduce without a thorough housecleaning and revision of the civil service system. For these reasons hopes for obtaining public savings in the budget are dim, at least for some years. With revenue lags, high public investment demand, and structural inertia in the public service, the pressure to resort to some deficit financing to undertake priority public programs probably cannot be resisted. The Commercial Import Program, which has been used as a major counter-inflationary instrument, cannot be continued indefinitely in that role and must be replaced by more normal monetary and fiscal measures. External aid should be turning toward development program support.

In these circumstances development will almost surely be accompanied by some price increases. The problem is to keep such increases within bounds or to have a guideline for monetary and fiscal policy to follow. Certainly the price increases of the past few years are unacceptably high as a guide to the future. Annual price increases of 30% or more are destructive. There are few standards of what a country can stand in price increases and still develop without severe strain, but we venture to suggest a twofold criterion. Average annual price increases over the years should be kept within the range of 5%-10%, and no price increase in a single year should exceed 15%. Obviously this is a crude criterion which must be examined carefully before acceptance. It may prove too rigid and inappropriate, but it is a place to start and is offered in that sense.

REGIONAL COOPERATION IN SOUTHEAST ASIA

The internal development problems of Vietnam rightly command the attention of the country as a program is planned for the decade after the war. The resources of the country belong to its people and the opportunities for development are measured in terms of those resources. Foreign trade must be cultivated to provide the foreign exchange to buy imports, but this trade is subject to rules different from those that apply to internal trade.

In the next ten years, although the emphasis is on national development, there almost surely will be opportunities for expanding development regionally throughout Southeast Asia, including all of Vietnam, Cambodia, Laos, and Thailand. Regional economic integration as a means to improve development possibilities for groups of nations has made remarkable progress in recent years, sometimes with quite remarkable benefits to the members, and sometimes not. But in principle, regional integration can accelerate the rate of growth and provide a wider and more stable basis for development. The opportunities among the countries of Southeast Asia can be explored much more thoroughly but some of the potential benefits, as well as the latent constraints, are discernible now and deserve mention in a report on development policies for Vietnam. In the long run the richest development of the country lies in cooperative development with its neighbors, and that is equally true for every other nation in the region.

There are many attractions in regional economic integration; it broadens markets for goods, widens the range of investment opportunities that are profitable because of the market effects, permits greater specialization in economic activities, which usually leads to cost savings, provides a way to channel financial and real resources to the best uses, and increases the economic power of the group in dealing with world markets. These are the potential benefits, and they are substantial. As a practical matter, there are political and economic difficulties in fully realizing these benefits.

Integration in this sense does not simply include a prescribed set of economic activities or functions. The European Economic Community has a full customs union plus cooperation and agreement in many other matters, whereas the Latin American Free Trade Association has made only a few tentative steps to reduce customs barriers and to cooperate on certain multi-national projects. Ultimate success in achieving benefits is more certain if the initial steps are simple ones that create some benefits to all without asking a sacrifice from any. With some small successes, it is easier to move to those ventures that require compromise and close cooperation. Such opportunities are often found in expanding trade among the countries on a liberalized basis of customs and regulations.

Trade expansion among the countries of Southeast Asia is a definite possibility, including the resumption of trade between North Vietnam and South Vietnam. In the past this latter trade was not insubstantial, with agricultural produce moving north and raw materials and some finished goods moving south. The composition of that trade would not be the same as before, because South Vietnam in particular has a wider range of products and costs and prices have changed, but some of the commodities previously exchanged mightagain be traded with mutual benefit. After the war the resumption of trade might well be a first step in a move toward normalization of relations. As a specific small step the re-establishment of postal communications has been suggested as one that would have particular appeal.

Beyond trade between north and south there are possibilities for trade among all countries in the region. It is sometimes said that trade among countries with very similar economies is apt to be very low and to contribute little to further cooperation, since each country seeks to market the same products. Although this is logically true, the actual situation is often quite different. This was the argument used against the small countries that formed the Central American Common Market, which is now probably the most successful of the regional associations. Upon examination, it is typical for similar product groupings in different countries to comprise a variety of different specific products, and for existing specialization or processing habits to create opportunities for trade. Differences in raw materials or natural resources similarly create trade possibilities. The economies of the countries of Southeast Asia are <u>prima facie</u> sufficiently different to support a greatly increased volume of trade among them. Moreover, industrial ventures among the countries, for instance for the exploitation of their joint forest resources to produce pulp and wood products on a large scale, extend the range of possible cooperative agreements.

Finally, the development of the Mekong River Basin is a multi-national project that can only succeed if the riparian countries cooperate. No single country in the region can derive benefits from the development of the part of the basin within its boundaries equal to the benefits that can be achieved through joint action. Hydro-electric power for industry and home consumption, flood control, and the provision of water to irrigate millions of hectares of agricultural land are the prizes to be won, but only if the countries can agree and obtain external assistance to finance the projects.

Regional economic integration may not initially rank high in priority in comparison to internal development measures, but plans for the future need to be made in advance and Vietnam should show its support for regional cooperation and for the activities of the Asian Development Bank, which is seeking every means to foster such economic cooperation.

CHAPTER 3 MONETARY POLICIES

INTRODUCTION

An appropriate set of monetary policies is essential for growth in Vietnam in the postwar period. Such policies are of equal, or even surpassing importance at the present time and in periods of rapid economic adjustment because they include controls over the money supply and the conditions under which credit is available. These controls operate through the commercial banking system and through other financial institutions. During a war period when normal fiscal policies are dominated by the need to support defense and total expenditure programs are swollen, major reliance for control of inflationary pressures in the economy fall on monetary policy and on direct governmental regulations of economic activity. In a peacetime economy, direct regulations can, and should, be largely replaced by normal fiscal and monetary measures that together will effectively stimulate the growth of investment, output, and income without severe inflationary or deflationary pressures. The combination of measures that are employed during a wartime, often including credit restrictions on the private sector, exceedingly high-levels of government expenditure programs (but almost none on developmental activities), large increases in currency, and varied direct restrictions, is generally quite different from the combination of measures required to stimulate growth. Changing such policies in the transition to a peacetime economy occurs during a time when many physical changes are going on in the economy. Monetary and fiscal policies are the key to successful conversion of the economy. A later chapter of this report discusses fiscal policies, centered on tax and revenue policies and government expenditure programs. This section discusses monetary policies for growth.

The actual content of monetary policy at each point in time in the future cannot be stated with precision, since it depends on the conditions existing in the economy. Nor is it necessary to be this precise. Monetary policy is a flexible instrument. It is possible to appraise the usefulness of specific kinds of policies, to indicate their likely effectiveness, and to state some rules for their application, including some things that should be considered in the near future.

Monetary policy is defined here to include the performance of three functions: (1) the building of a financial sector in the economy that will adequately provide financial services for the economy and the establishment of conditions so that these institutions (commercial banks and financial intermediaries) will respond to changes instituted in credit policies or the money supply; (2) the establishment of policies to stimulate savings and investment in the economy, and through credit policies, help to maintain external equilibrium in the balance of payments; (3) the creation of conditions for a successful money or capital market in the future. These functions are not completely separable, but each has some distinctive features of importance for the future growth of the economy.

THE FUTURE IMPORTANCE OF CURRENT MONETARY FACTORS

It is difficult to write of postwar monetary problems without a complete description of the economy as it transforms from the war to the peace. The problems of the day to day control of credit and money to keep the economy in reasonable balance are not the primary concern of a report aimed at postwar problems. Yet the problems of today do leave a legacy for tomorrow and we must try to take account of the elements that will persist into the future.

At the present time the major problem is the continuing inflationary pressure generated by war finance, where injections into the monetary system via issue of currency and advances from the National Bank exceed the absorption of funds via taxes and other revenue measures. This "inflationary gap" has been widening and probably will continue to do so as long as the war continues. The pressing problem is to find a way out of the dangers of this inflationary situation for the next few months or a year. Each time a budget is prepared, the same problem recurs, and additional monetary and fiscal measures must be found to offset increased levels of expenditure. This problem, which is so central to immediate short-term monetary policy, may carry over into a postwar period. It does not seem likely that total expenditure programs (including those associated with the U.S. military) will suddenly decrease, regardless of how negotiations go or what solutions are reached. There may well be sharp decreases in certain U.S. military expenditures (such as troop payments) but these will not have an impact within the country. A serious deflationary process does not seem at all likely in the transition; vestiges of inflationary pressures will probably persist for some time. This is an evaluation and a judgment that could prove false of course, if, in particular, peace brought a rapid demobilization accompanied by a sudden fall in U.S. external aid, but that combination of elements appears to be improbable.

The expansion of the money supply seems not to have induced an equal increase in prices, though it may be simply that the impacts are delayed. A calculation of the effects of changes in the money supply on price changes indicates an elasticity of almost one; that is, a 1% increase in the money supply leads to a 1% increase in prices, but with a delay of about six months. The full impact of the changes in the money supply will not be felt for some time.*

Yet it does appear that some part of the increased money supply is going into hoards. The usual methods for the flight of capital - gold sales, retention of export proceeds overseas, direct bank transfers, over and under-invoicing of imports and exports, etc. - have not shown any great evidence of activity, and prices have not risen dramatically although the money supply has. This hoarding has been attributed to feelings of uncertainty by the people as to what will happen in the future, particularly after the experience of Tet, 1968. They are assumed to be withholding decisions to spend for durables or similar goods because of this uncertainty. The fear is that these hoards of currency may be dishoarded in a short space of time and create inflationary chaos. Paradoxically this change in attitude could occur either through a return of confidence in the future, leading to a decision to spend the funds, or through a worsening of confidence in the value of the currency. The latter situation is by far the more serious. If an inflationary gap grows and currency is printed, it is conceivable that a hyper-inflation might develop that could not be checked by an increase in imports. The present inflationary pressures generated by excess demand are very likely to continue into the future and complicate monetary problems of the

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* Derived from a regression of percent changes in the money supply to percent changes in the consumer price index for working class families, with the change in the money supply lagged six months. This was for the period 1960 - June, 1968. The regression equation is:

$$\dot{P} = -.76 + .94\,\dot{M}$$

where $\dot{P}$ is the change in prices and $\dot{M}$ is the change in the money supply.

transition to peace.

The inflationary situation is not helped by the policies that have been followed on interest rates. One reason people hold cash is because, with a low interest rate on deposits, it does not cost much to hold currency. They are not losing much of a return and they prefer the higher liquidity that currency has over bank deposits. A higher level of interest rates might induce people to hold deposits and other assets rather than cash and through this reduction in liquidity reduce inflationary pressures. For this and other reasons related to incentives to save the present structure of interest rates is an unreasonable one and clearly needs revision. The appropriate kinds of policies and levels for interest rates both now and in the future are discussed later in this chapter. The suggestions made there are among the most important in the area of monetary policy.

Finally, the current imbalances in imports and exports have created strains on the exchange rate that only a specially designed import program and external aid have kept within bounds. The free market rate has fluctuated rather widely. The determination of the appropriate exchange rate for the future - one that will be reasonably stable, not impair growth nor feed inflation, and one that will permit a reasonable balance of payments to be maintained - is one of the prime problems that must be faced. This issue is also discussed later in this chapter.

THE FINANCIAL STRUCTURE FOR THE FUTURE

As Vietnam develops growth will occur in all sectors of the economy, though some will grow faster than others or receive a higher priority of treatment. The financial sector is one that is sometimes overlooked in terms of the growth of essential economic functions. It includes the commercial banks, the special investment institutions (the Agricultural Development Bank, the Vietnam Development Bank, and the Industrial Development Center), plus institutions that may be created (mortgage banks, savings and loan-type associations, insurance companies, etc.). These provide the means for moving away from quasi-barter type arrangements and bringing more of economic activity into the monetary economy. Through them it becomes easier to pay bills, to carry on business, to obtain credit for productive investment or for consumption needs, and to stimulate the increase of savings and capital. These are functions that need strengthening if agriculture, industry, and trade are to grow and prosper. In short, they are instruments for mobilizing savings and capital, and for helping to make monetary policies effective.

By most standards the financial sector in Vietnam is weak and underdeveloped, and this condition is not solely traceable to the war. It apparently has existed for a number of years. There has been a growth in financial assets and financial activity, sometimes at rather high rates, but virtually all of this has taken place in the last two years, and much of it is due to the rapid growth of import trade in this same period. Since in the postwar years the level of imports will almost certainly shrink from the peaks realized during the war, this recent growth may not be firm enough to sustain continuous future development in this sector.

One comparative measure of the characteristics of the financial system is briefly shown in the table, "Commercial Banking Structure in Selected Countries (1967) which compares the number of banks and number of persons per banking office for Vietnam and five other countries. The contrast between Vietnam and neighboring countries is readily evident from the numbers; the Philippines has more than twice as many banking offices per unit of population as does Vietnam and all other countries in the selection are better off. Japan has one banking office per 15,000 and the U.S. one per 6000. But a few years ago the contrast was even greater; seven of the twenty banks in Vietnam were established in 1965 or later, and only fourteen of the thirty-seven offices are in the provinces. Twenty-three are located in the Saigon-Cholon area. Some market towns have no banking offices at all.

The absence of commercial banking facilities has surely had an adverse effect on the conduct and growth of business and trade in the country. Because of a lack of such bank credit sources and financial services, other more informal arrangements have been made to supply minimal needs. Credit is supplied by merchants, relatives, and money-lenders. In the case of the first two, funds are apparently often lent at zero interest but the coverage of such a system is sharply limited to family or close business associates. For example, major fish merchants in Saigon will lend money to their provincial suppliers. Borrowing from moneylenders is done at very high interest rates and often short maturities. It is not a stimulus to normally profitable ventures. The local institution of the "hui" is widely used in Vietnam but it has been shown that it frequently leads to implicitly irrational economic choices in the use and commitment of funds.

TABLE 3-1

Commercial Banking Structure
in Selected Countries (1967)

Country	No. of Domestic and Foreign Banks	Total Number of branches	No. persons per banking office (thousands)
1. Vietnam	20	37	440
2. Taiwan	17	306	43
3. Korea	17	236	122
4. Pakistan	25	1747	62
5. Thailand	27	324	96
6. Philippines	37	188	175

These informal credit arrangements cannot be expanded to meet the needs of growing commerce and industry during a development period. They will probably not be completely supplanted by banking operations for a rather long time, longer than the ten year horizon for development planning that is taken in this report, but a movement should be made to provide incentives to expand commercial banking throughout the country in the postwar.

The Government of Vietnam has taken some steps via tax concessions to make it more attractive to establish branch banks in the provinces. In the present circumstances these probably will be only partially successful, but may be increasingly effective in the postwar. In any case the expansion of commercial banking facilities should be in the hands of the private sector, though the Credit Commercial (CCVN), a government bank, has more provincial branches than any other, and should be encouraged to supply competitive market pressures on private banks to expand their operations.

To some extent the expansion of facilities after the war may occur naturally. The business of the banks has been concentrated primarily in the financing of imports, which has accounted for over 50% of total business. The ease and profitability of import financing are also the reasons for the establishment of the new banks after 1965. Funds can be turned over three or four times a year and the risks are small. It is a classical example of old "commercial banking theory" that loans be self-liquidating. The banks have not been aggressive in searching for loan opportunities in industry and agriculture, nor in developing savings departments. The former opportunities have been largely left to the special banks : the Agricultural Development Bank (ADB), the Vietnam Development Bank (VDB), formerly SOFIDIV, and the Industrial Development Center (IDC), and the development of further loanable funds via savings departments has been impaired by the interest rate policies of the central bank, the National Bank of Vietnam (NBVN).

The commercial banks have naturally concentrated on the most lucrative lending in imports, but after the war, the volume of imports will probably drop, as has been mentioned earlier; therefore, the banks will have to pursue a more aggressive policy in developing business with industry, agriculture, and commerce, and, in fact, it is necessary that they do so if the credit needs of these sectors are to be met. This should not require any special incentives by the Government, though it may require some education in aggressive and effective banking practices by the banking community.

There are four special financial institutions that provide credit and financial services. These are the Agricultural Development Bank, the Vietnam Development Bank (formerly SOFIDIV), the Industrial Development Center, and Caisse de Refinancement pour le Devéloppement de L'Industrie (the refinancing fund). In general they make short-term and medium-term loans. At the present time they do not make loans for longer than about seven years at interest rates that range up to about 8%. We are not concerned here with the rules and regulations governing the operation of these institutions. They are dictated in large part by the present conditions of the war. But there are two important questions concerning their functions and operations in the postwar. The first is a question of their future relationships with the commercial banks, the division of responsibility for supplying credit and the amount of competition or cooperation among them. The second question concerns the amount of loanable funds that these institutions will have available in the future and the appropriate source of such funds.

Many of the funds available to industry and agriculture now originate with these institutions. As has been mentioned above, in the future the commercial banks should also be sources of credit for these sectors. There may be competition for loans between these institutions and the commercial banks but this is not a very likely event. In all probability the demand for loanable funds will be greater than can be supplied by all of the banking community unless vigorous efforts are made to stimulate savings. This problem is discussed in the following section of this chapter. These four special institutions should provide a lead in meeting credit needs but they will not be able to supply the major part. Their funds now come through the Government and while an increase in such funds can be obtained and may be virtually the only source in the short run, over a longer period of time these institutions should explore the possibilities for obtaining funds through the sale of their own securities. This would permit them to tap a wider money market.

Just as the refinancing fund now is the means for banks to obtain additional funds for industrial development, at some time in the future it might be appropriate for the Agricultural Development Bank to assume this additional responsibility in the case of agricultural loans. This would place these institutions in a position to exercise some additional degree of restraint on or stimulation to the commercial banks.

The more important question is what level of loanable funds or bank credit will be required in the future to finance investment and rising economic activity. There can be no very precise answer to this question. Much depends on the composition of investment, the rate of growth of markets, the extent of government participation in programs, and many other factors. In Chapter 7 of this Report (Agricultural Development) a special estimate is made of agricultural credit needs over the next ten years. The estimate of VN$ 30 billions is about ten times the amount now in use. Chapter 9 (Industrial Development) outlines a large list of industrial projects that may be undertaken in the next ten years, with explicit estimates of fixed capital financing requirements but without estimates of actual credit needs. These are only two of the sectors. Housing mortgage needs is surely another large one.

Some rough ideas of credit needs in the future can be obtained by reference to other countries. For a sample of countries the average ratio of bank credit to the gross national product is about 30 percent. Normally credit needs rise somewhat more rapidly than the rate of increase of the GNP so that for a rate of increase of 5% - 6% in the latter credit requirements might rise by 7% - 8% annually. This assumes that the basic relationship between credit needs and GNP from which growth takes place is at least 10% - 15%; otherwise the rates of increase may be higher. Table 3.2, Financial Ratios in Recent Times shows how low this ratio is for Vietnam. In the past two years credit expansions have been unnaturally swollen by import financing, but except for 1966 the ratio is deliberately held down as a war measure to curb inflation; but, however, the experience of the early sixties does not show much tendency to grow.

Crude estimates can be misleading, but it appears that credit needs in Vietnam in the postwar for a growing economy will be five to fifteen times the amounts now available, assuming a vigorous private sector. For that reason it is important to encourage strongly the growth of savings through appropriate policies (which are discussed in the next section) and to consider how public sector revenues may be raised and made available for investment (which is discussed in Chapter 4).

Finally, the composition of the money supply and its relationship to the GNP also suggest some structural problems for the future, as well as indicating some of the monetary policy problems in the short run in control of inflation. For a country with Vietnam's per capita income the total money supply is typically about 13% - 15% of GNP and currency is about 65 percent of the total*. As Table 3.3, Relationships of Money Supply and Components to GNP shows, the money supply is 20% - 25% of GNP and very likely will rise in the next few years. Structurally this is the level appropriate to a country with a per capita income of over $300, at which level more activities are monetized. This level of per capita income is three or four times that for Vietnam. The ratio is high because of the inflationary kind of finance that has had to be used during the war. Moreover, the ratio of currency to the money supply is exceedingly high, 75 percent in the most recent year,

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* Derived from equations fitted to data for about 70 countries.

$$M/GNP = -6.57 + 4.74 \ln GNP/P$$
$$C/M = 114.31 - 11.38 \ln GNP/P$$

where M is the money supply, C is currency, P is population and "ln" means the natural logarithm. J. Gurley, "Financial Structures in Developing Countries", in Fiscal and Monetary Problems in Developing States, Proceedings of the Third Rehovoth Conference (New York, 1967).

TABLE 3.2

Financial Ratios in Recent Times
(VN$ billions)

	Bank* Credit	Time ** deposits	GNP	B / BNP	T / GNP
1960	4.3	.9	81.8	5.3	1.1
1961	5.7	.9	84.5	6.7	1.1
1962	6.9	.9	93.8	7.4	1.0
1963	7.5	2.0	100.3	7.4	2.0
1964	7.6	2.2	114.3	6.6	1.9
1965	7.4	2.8	144.8	5.1	1.9
1966	29.2	8.3	240.9***	12.1	3.4
1967	27.3	8.3	352.0***	7.8	2.4

* Loans and investments to private sector.
** At commercial banks.
*** Preliminary estimates.

TABLE 3.3

Relationships of Money Supply and Components to GNP
(VN$ billions)

	GNP	Currency	Demand deposits	Money supply	$\frac{C}{M}$	$\frac{M}{GNP}$
1960	81.8	11.2	5.5	16.7	67.0	20.4
1961	84.5	12.2	5.0	17.2	70.9	20.4
1962	93.8	13.2	6.3	19.5	67.8	20.8
1963	100.3	15.5	6.8	22.3	69.5	22.2
1964	114.3	19/0	8.4	27.4	69.3	24.0
1965	144.8	32.8	14.8	47.6	68.9	32.9
1966	240.9	46.0	17.4	63.4	72.6	26.3
1967	352.0	62.2	20.4	82.6	75.3	23.5

indicating how relatively little demand deposits (and time deposits) have grown. Currency is the most liquid of monetary or near-money assets, and the large amount of currency in circulation raises the possibility of a big increase in velocity in a short time, one that might be difficult to control. In the postwar a redress of these monetary relationships will have to be made, but also there is a question whether a different interest rate policy even now would not operate to decrease the liquidity of the system.

INTEREST RATE REFORMS

The short-run requirements for policies to help control inflation and the longer-run development requirements for savings to finance productive investment are both dependent in part on an appropriate structure and level of interest rates. It is quite evident that neither set of requirements is met by the present structure of rates and that interest rate reform is perhaps the major problem for monetary policy.

The immediate problem of inflation control is not strictly our concern. It is the responsibility of officials of the government who must prepare policies to meet current needs. Moreover, the controls on inflation lie more in the area of tax and other fiscal measures than in the area of monetary and credit policies directly, though both kinds of measures are needed. Credit to the private sector has been limited to prevent undue inflation from that source.

It would also be desirable to raise interest rates now, to encourage the transfer of holdings of cash to deposits and other quasi-money. The purpose is to decrease the liquidity of the monetary system, which, as has been indicated above, is extremely liquid and, because of that fact, poses an inflationary threat. The interest rate structure is unrealistic and should be revised upwards.

It is possible that a sharp rise in interest rates would not be immediately effective. If confidence in future developments in the war and in the economy is shaken, the incentive provided by higher interest rates may not be sufficient, for any reasonable increase, to cause people to part with the liquidity offered by holding currency. This may, of course, be the case now, but this condition probably will not continue at its present intensity and there will likely be favorable effects on those individuals who do not feel so uncertain, who are willing to take somewhat greater risks, and who are attracted by the higher rates. Such groups exist particularly among commercial classes who hold substantial amounts of currency.

Since the interest rate is one of the "prices" in the economy, some may argue that an increase in this price will cause a rise in other prices, particularly of imported goods. But generally the interest cost is a small proportion of total cost and the effects of a rise in interest rates would be minimal. The rise in interest rates need not be equal across all kinds of loans and deposits. Through differential treatment the rates on deposits with varying maturities can be increased and the rates on loans of different kinds can be adjusted to a small increase. More is said on this point later in this section. Such adjustments would not have a serious effect on bank profits which now apparently run between 25% and 60% annually.

The stimulation of domestic savings to finance investment is necessary to prevent the gap between the two from hampering development programs or from throwing the burden increasingly on inflationary methods of finance. There are several ways that resources can be diverted from current use to capital use. One of these is through the inflationary process which tends to put funds into the hands of those who are likely to invest it. But inflationary methods of finance distort the economy and in general are self-defeating. The history of experience in a number of countries is evidence on this point and need not be reviewed here. Inflationary methods should not be relied upon for providing the funds needed for the development of Vietnam. This is not the same thing as saying that development can take place with strict price stability, since that normally is accomplished only with the most careful balancing of policies, but it does mean that no long run consistent policies of deficit financing of investment and issue of new currency should be followed.

Through the raising of taxes and other revenue measures the government may acquire resources (savings) for use in development projects, providing that current operating costs of the government are prevented from rising as fast (or faster) than revenues. The possibilities for raising revenues and government savings in the postwar period are discussed in Chapter 4. During the present war condition, government savings are negative and are almost certain to remain so.

At the present time the level of interest rates on deposits and loans in Vietnam is summarized briefly in Table 3.4, Structure of Interest Rates in Vietnam. Time deposit rates are graduated according

TABLE 3.4

Structure of Interest Rates in Vietnam

Item	Rates Actually Applied	Maximum Rates Permitted
1. Interest rates on deposits: commercial banks		
a. Demand deposits		
(i) Under VN$ 300,000		2
(ii) Over VN$ 300,000	0.5 - 1.5	2
b. Time deposits		
(i) 1 to 3 months	3)	4
(ii) 3 to 6 months	3.5)	
(iii) Over 6 months	4	6
c. Savings deposits		
(i) Maximum VN$ 50,000	3	4
(ii) Over	2	4
2. Interest rates on loans: commercial banks		
a. Secured loans	7 - 8	8
b. Unsecured loans	9 - 10	10
3. Agricultural Development Bank		
a. Short-term (under 18 months).		
(i) Marketing, mfg.	8 - 10	
(ii) Production	12	
b. Medium term (18 mos. - 5 yrs.)	8	
c. Long term (over 5 years).	suspended	
4. Industrial Development Center	6.5	
5. Vietnam Development Bank	6.5	

to the period held but the differential is only 1%, and the maximum allowable rate on time deposits is only 6% and 4% on savings deposits. Since in the last two years the rate of increase of prices has been 30% to 60%, the real rate of interest in Vietnam is highly negative. It is remarkable that time deposits have even held at a steady level during this period and certainly they could not in such circumstances have been expected to rise.

Both Taiwan and Korea have, in the recent past, deliberately pursued a policy of raising interest rates on deposits and loans, as an anti-inflationary measure and to increase savings that could be channeled into productive investment. The experience of these two countries and the conditions that gave rise to the adoption of such policies are very relevant to the situation in Vietnam now, and are equally important to the establishment of interest rate policies for the development period. *

In 1949 and early 1950 Taiwan had a rapid increase in the money supply and prices, the former increasing almost ten-fold between mid-1949 and mid-1950. Prices increased less rapidly but had almost tripled by mid-1951. The government in early 1950 attacked the inflation through a policy of paying high interest rates on time deposits. Certificates of deposit were issued for bank deposits with varying maturities. The first offering was for certificates of one-month maturity and with an interest rate of 7%; at an annual rate this is 125%. The response of savers was rapid, and time deposits rose eighteen-fold in five months, and the price increases stopped at least for a time.

Over the next several years a number of refinements in the system were made. Certificates of deposit for three and six months, and one and two years were introduced. At first only one-month certificates were issued but as confidence was restored and the economy stabilized, the certificates with longer maturities were issued and quickly accepted.

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* Cf. R. J. Irvine and R. F. Emery, "Interest Rates as an Anti-Inflationary Instrument in Taiwan," May 20, 1966. Also R. F. Emery, "The Korean Interest Rate Reform of September, 1965," October 3, 1966. Mimeographed papers issued through the Division of International Finance, Board of Governors of the Federal Reserve System.

Initially the interest rates per month were quite high, for example, 4.0 percent on three-month certificates, 4.2 percent on six-month, etc., but these gradually declined, and within a few years the rates were .85 percent on three-month and 1.35 percent on six-month, with somewhat higher rates for one and two years. The structure of rates was adjusted to the set of maturities, with the lowest rates on the short-term certificates and higher rates on those with longer maturity. At one point bonds were issued with interest rates up to 18 percent. These bonds matured in two and a half years; no long-term securities (over five years) were issued because the objectives were achieved with the short maturities, but it is evident that the market was prepared to absorb long-term bonds if they were issued.

Korea followed the lead of Taiwan in pursuing a high interest rate policy to stimulate savings. In 1965 Korea dramatically raised the rate on time deposits from 15 percent to 34.5 percent; savings deposit rates were raised from 3.6 percent to 12 percent and the rates on all other types of deposits (except demand deposit rates) were similarly adjusted. Loan rates were also raised but not all types of loans were treated the same. Loan rates for export trade and on rice liens were left at lower levels; the discount rates on commercial bills was raised from 10-15 percent to 28 percent. These policies were successful in stimulating savings and did not have noticeable unfavorable effects on investment.

The lessons of the Taiwan and Korea experience are important ones for Vietnam to learn. They did not accept the standard doctrine on interest rates, that low rates are a necessity or that 6 percent is sacred, and they broke through to levels that caused substantial increases in savings. The interest rates used were high by usual rates in less-developed countries, but these rates were steadily decreased as time went on. At first short-term certificates of deposit were issued but gradually people learned to have confidence in longer maturities, and they were actively subscribed. Commercial bank profits were protected, in part by the central banks who paid interest on reserves or otherwise paid a subsidy to offset the potential losses from the high deposit rates. But loan rates were raised, though not uniformly. Loan rates for productive investment in agriculture and industry were not increased very much.

As an anti-inflationary measure now and as a prelude to a postwar program to raise savings significantly, it is suggested that the Government undertake an interest rate reform. The actual details and operating procedures are matters for the National Bank and the appropriate Ministries to decide, in conjunction with the commercial banking system, but the general features of such a reform cover the following steps:

1. The issuance of three or six month certificates of deposit carrying an attractive interest rate. (Specific suggestions on the rate are being submitted in a separate document). It might be prudent to "test" the market by first trying a short maturity certificate. The exact terms to be offered are best left to the National Bank in consultation with others. The situation in Vietnam is different from the situations in Korea and Taiwan, and a longer term certificate may be successful. The terms should be such that the probability of achieving a significant volume of certificates by individuals and business is high.

2. Plans should be made for additional issues, assuming the first test is successful. Later issues can probably be longer maturing and with lower interest rates, if the Taiwan and Korea experience is any guide. Ultimately a range of short and long-term certificates can be employed as a tool of monetary policy.

3. Loan rates on most classes of loans by the commercial banking system should be approximately doubled, but possibly with discount rates on commercial paper increased more. Preferential treatment might be given to loan rates of the Agricultural Development Bank. They might be retained at present levels or raised a nominal amount. The loan rates of the VDB and IDC should be raised roughly to preserve their present relationship to commercial bank rates. The appropriate mix of rates among classes of loans and institutions is one requiring very careful study.

4. The effects of such changes in both deposit and loan rates on commercial bank profits and incentives should be watched. Care is needed not to create windfall profits for banks that are turning over their money rapidly in the finance of imports. For that reason some narrowing of the margins between loan rates and deposit rates is probably justified. Bank profits have been very satisfactory, to say the least.

5. Consideration is needed of the appropriate rate on Treasury bonds and the 20 percent requirement on commercial banks for purchase of such bonds. Initially it may be unnecessary to adjust

these, but an analysis is needed of the interaction of the suggested interest rate reforms and these elements.

The suggested program of action outlined above is intended to move in the direction of a more effective monetary policy both in controlling inflation through reduction of liquidity and to establish the basis for more intensive cultivation of savings.

CREATION OF A MONEY AND CAPITAL MARKET

In the postwar period there will be a need to establish expanded facilities for a money and capital market. By doing so the National Bank can have an additional means through which to exercise monetary policies and such a market can help to get wider distribution of Government securities and, later on, securities of quasi-public and private companies. The creation of such a market probably cannot be instituted now. As has been indicated previously, the commercial banking system and the set of other financial institutions are relatively underdeveloped, and it will take some time to strengthen them. However, in the Saigon-Cholon area there is a fairly heavy concentration of banks which presumably would form the nucleus for such an undertaking.

In the past there was a very informal money and capital market, known as the "Lefebvre" market, and some say it still operates. The dealers and brokers met informally in the coffee houses around Ham Nghi and Vo Di Nguy. Apparently this informal market has served the limited purposes needed, and possibly the participants would be included in a more formal market built around the commercial banking system. The initial purpose of a money market should be for the sale and distribution of Government short-term securities and to broaden the base for them. For example at the present time about 95 percent of treasury bills are sold to commercial banks and only 5 percent to other kinds of purchasers. It will be desirable as part of monetary policy to have a wider range of Government short-term securities with differing maturities and interest rates. It must be emphasized that the creation of such a market will not be successful without the interest rate reforms that have been recommended above. At the present low interest rates, it is unlikely that there would be much of a market for Government securities. Treasury bonds must be purchased by the commercial banks up to a fixed percentage of their deposits. Later on, with the expansion of financial institutions and credit instruments - and with interest rate reform - it should be possible to remove the requirement on the commercial banks for fixed purchase of treasury bonds and permit them wider latitude in arranging their portfolios.

Ultimately the money market should be a means through which the National Bank could market a wide variety of treasury bills and bonds, which will strengthen the hand of the National Bank in monetary policy. Moreover at some time in the future, it undoubtedly will be desirable for the Agricultural Development Bank and the Vietnam Development Bank to float bonds for the purpose of adding to their reserves to be used for loans to agriculture and industry. It may be noted, for example, that the Philippines Development Bank has issued bonds which are convertible into the preferred and common stock of private corporations in which the Philippines Development Bank has acquired an equity. This is one means to obtain wider distribution of the ownership of private securities, and it is recommended for Vietnam as well.

Normally the establishment of a primary money market built around the commercial banks and selected other financial institutions results in the creation of a secondary market involving other kinds of purchasers including private individuals. The same should be expected in Vietnam, with a consequent strengthening of the whole money market.

Stock issues by private companies in Vietnam typically take two forms. For small private companies, the stock is sold to relations and friends. Larger companies have issued their stock in Paris and their shares are traded on the Paris Bourse. Some changes will be required in stock issuing practices in order to broaden the sale of such securities; for example, nominal stock will have to be denominated in a way to make it marketable. Initially the sale of stock of private companies would be through the commercial banking system but as demand and supply conditions warrant, a more formal securities market might be established. There was in the past a draft decree for such a market, but it was not implemented. The necessary condition for the successful establishment of a securities market is that there be sufficient bid and asked prices so that the price ranges do not fluctuate widely; otherwise there is a lack of confidence in the effectiveness of the market.

It is expected that a strong and persistent element of investment in the postwar will be in housing and home construction. At present there is no efficient home mortgage market, and no institution to mobilize funds and make loans for these purposes. This is a lack that should be corrected. The creation of a special home mortgage bank, patterned roughly on the Agricultural Development Bank, is the appropriate way to meet the problem. It could have features both of a mortgage bank and a savings and loan association, and should have the latitude and flexibility to set mortgage terms to stimulate home building. Care should be taken to prevent the bank from being used simply to finance the speculative building of apartment houses in Saigon. This is relatively simple to do through direct regulation or loan policy. The bank should also make every effort to stimulate savings deposits so as to acquire funds for loans. Initially funds from the Government are needed to give it a start. Plans can be made now for the creation of a home mortgage bank.

It should also be pointed out that the growth of insurance and similar types of financial business will create funds that will seek investment in government or private securities. They should be expected to help stabilize such money and capital markets.

These suggestions do not have a high priority by comparison to other development programs, particularly in the early postwar phases when the economy is making a transition to peace, but some preliminary plans can be made by the National Bank in cooperation with the commercial banks so that the steps to create such markets are thoroughly understood and are ready for implementation.

EXCHANGE RATE POLICY IN THE FUTURE

It is the responsibility of the monetary authorities of a country to maintain a reasonable equilibrium in the balance of payments through exchange rate policies and appropriate credit and fiscal measures. Equilibrium is not synonymous with a neat balance of receipts and expenditures, but is defined as a condition without severe pressure on the exchange rate and reserves, without concurrent internal inflationary effects, and without rapidly mounting debt service charges. The definition is necessarily somewhat inexact, since an equilibrium in the balance of payments can be maintained with varying levels of these elements.

The war has, of course, badly unbalanced the accounts. Exports have dropped to very low levels and imports have risen drastically, till now imports are roughly 25 to 30 times the amount of exports. The large deficit in the balance of trade is met through favorable services payments (that is, spending of troops and contractors) and external aid. In fact, imports have been used as a primary anti-inflationary measure, designed to sop up purchasing power and hold down prices. They have almost been allowed to rise without limit. Obviously this set of conditions cannot continue in the indefinite future. The level of imports will drop and the level of exports must rise, but external aid will still be required for some years. These issues are discussed elsewhere in this report. We are concerned here with the question of whether the current exchange rate of VN$ 118 to US$ 1 is likely to be viable in the future.

The free market rate (as represented by the Hong Kong rate) has in recent times been 50 to 70 percent above the official rate, and although it has fluctuated somewhat in response to favorable and unfavorable market conditions in Vietnam, it has shown no signs of eliminating the discount from the official rate, particularly if inflationary finance continues.

The "real" exchange rate has of course deteriorated a great deal since 1966. The "real" rate is the official rate of 118 deflated by an appropriate price index, normally the wholesale price index. In this sense the "real" rate (as of December, 1968 with a wholesale price index of 405) is only about 30, which has the effect of further stimulating imports and, in normal circumstances, depressing exports. Thus the effect of an over-valued rate is to unbalance foreign trade to an appreciable extent. This is further evidence that an appropriate adjustment of exchange rate policy is required.

At present levels of national income and output and current price ratios of domestic and imported goods, the piaster is almost surely an overvalued currency at an exchange rate of VN$ 118. At these levels, the demand for foreign exchange exceeds the supply even if the distortions brought on by the war are eliminated. Only if there were a drastic scaling down of the whole structure of prices and wages, and of incomes, is it likely that demand and supply would be equated somewhere near the price of VN$ 118, and such a structural deflation would almost surely be disastrous for the country. Some readjustments in the wage-price structure are needed, but not to the extent implied by the present exchange rate.

Devaluation is a painful action to contemplate at any time. As a practical matter the action must be safeguarded with controls over capital and credit to prevent capital flight and bank withdrawals in anticipation of the action. In retrospect the devaluation of 1966 appears both necessary and successful for its time, and in the postwar period a further devaluation is required. Since it is more damaging to confidence in the economy to have numerous adjustments, either formal devaluations or *de facto* ones, the objective of exchange rate policy in the future should be to make a once-and-for-all adjustment that can be maintained and that will contribute effectively to equilibrium in the foreign exchange market at a level consistent with development needs.

It is precarious to try to estimate the extent of the devaluation that is needed without knowing how and when peace will come and the levels of incomes and finance at that time. Some specific suggestions on an appropriate rate are being submitted in a separate document. An adjustment in the official rate of VN$ 118 is needed to bring about reasonable equality in demands and supplies of foreign exchange, after making allowances for some natural shrinkage in imports, an expansion of exports through direct investment in specific export industries, and no serious postwar deflation in incomes.

The perequation tax, which was introduced to equate import prices of United States goods and those from other markets, is equivalent to multiple exchange rates in practice. Chapter 4 of this report argues the needs for customs duties reform to simplify the system and to provide appropriate incentives and revenues. The perequation tax is a cumbersome, complex addition to the system of import duties and probably should be abandoned. If that is done, the exchange rate should be adjusted to take account of the average effect of the tax.

In short an exchange rate adjustment will be required in Vietnam. The effects of such an adjustment in stimulating exports should be highly beneficial to future development, and the dampening effect on imports is equally welcome. The problem is one of timing, of choosing the appropriate rate, and, most importantly, of mobilizing all other policies -- monetary, fiscal, and direct incentives to production -- to prevent an internal inflation or at least to minimize it. This calls for careful planning and a firm hand in applying the measures.

The alternative to devaluation is reliance on complicated regulations, licenses, and controls on imports, special subsidies to exports, and a whole range of measures to control internal prices. And the likelihood of success is very small indeed. At best it would simply postpone the inevitable at a cost of introducing further distortions in the economy. Vietnam is now a high cost economy, in contrast to other Asian countries. A devaluation is virtually the only means to redress the balance, since wholesale deflation is ruled out. We believe the adjustment of exchange rate policy is of the greatest importance to the future health of the country.

It is far more injurious to have an overvalued currency than a somewhat undervalued one. The latter provides incentives for export-driven growth and can hardly be viewed by other countries as unfair competitive devaluation. What is needed in Vietnam is a stable rate that will contribute to confidence and to incentives for development investment. Preliminary plans need to be made now to determine the likely level that will be established under some alternative sets of circumstances.