MEMORANDUM

NATIONAL SECURITY COUNCIL

INFORMATION

September 2, 1970

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Laird Smith

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MEMORANDUM FOR DR. KISSINGER

FROM: K. Wayne Smith

SUBJECT: Vietnamese Economy

Purpose

In response to your request, this memorandum discusses the Vietnamese economic situation, the results of the VSSG economic analysis, and the status of the pending GVN economic reform.

Background

The cost of the war to the Vietnamese economy, as measured by the GVN defense budget, is about 20% of the gross national product (GNP) of South Vietnam. This compares with a U.S. defense budget/GNP ratio of 10%. For most countries of the world, this ratio is less than 5%.

The GVN has never, however, been able to pay even half of these war costs. The narrow base of the GVN tax system and the political cost of taxing the population while trying to win its support prevented the GVN from mobilizing more resources. Thus, since 1965, the U.S. has funded about two-thirds of the total Vietnamese war costs:

U.S. Share of GVN Defense Costs

1968	1969	1970
65%	71%	67%

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Had the GVN been able to implement an extensive tax reform to increase the domestic resources mobilized for defense from 7% to 20%, instead of relying on U.S. support, such measures would have caused Vietnamese incomes to fall sharply. Moreover, this would have conflicted with the GVN/U.S. goal for gaining the support of the South Vietnamese people, particularly the majority in the countryside.

In simple terms, the GVN could not and would not have done more; therefore, less U.S. dollar support would have resulted in less war effort by the GVN.

However, aided by U.S. resources, assistance which rose from $242 million in 1965 to $636 million in 1970, RVNAF forces increased from 569,000 in 1965 to 1,078,000 in 1970.

The VSSG Analysis of FY 1971 Assistance Requirements

The VSSG reviewed the alternatives open to the U.S. for FY 71 and beyond. It suggested that on the basis of the following factors increased U.S. assistance might be needed:

-- (1) In accordance with Vietnamization, Vietnamese forces will take up part of the war burden carried by U.S. forces. RVNAF will be expanded, particularly in logistics and support units, and RVNAF forces will operate more intensively, increasing operating costs. GVN defense costs will rise by about 10%.

-- (2) Since 1965, military wages have risen less rapidly than the cost of living. This decline in real earnings of between 25% and 50% is a serious threat to Vietnamization.

There is evidence that low incomes have had a harmful effect on military performance. For example, low incomes are a principal cause of desertions. Thus restoration of the real value of official wages is a key aspect of Vietnamization. The required funding would raise defense expenditures by at least 30%.

Based on these two considerations alone, an increased in net U.S. assistance of roughly 40% or $200 million over the net 1970 U.S.

assistance level of $479 million would have been required. (Gross U.S. assistance in 1970 was $636 million, but $157 million of this paid for U.S. consumption of South Vietnamese resources rather than Vietnamese defense costs.)

On the other hand, however, the VSSG analysis suggested that on the basis of the following considerations reduced U.S. assistance might be in order:

-- Further increases in Vietnamese private incomes might be undesirable.

First, in the past the political benefits that accrued to higher incomes resulted primarily from gains that increased earnings to a subsistence level. These gains ameliorated serious grievances played upon by the communists. Beyond this, however, further income gains have a much smaller political benefit in terms of increasing the relative attractiveness of the GVN. (It was thought that programs such as land reform stood the best chance of gaining support for the GVN.)

Second, with Vietnamese exports of $ 50 million compared with imports of $700 million, the prospects for Vietnamese economic self sufficiency even if the war ends are remote. The Vietnamese economy has become almost totally dependent on foreign assistance. Higher private incomes would further increase this dependence. Domestic political considerations within the U.S. and South Vietnam strongly imply that this is an unwise course of action.

In sum, these findings suggested that private incomes should not rise in the future. Rather, increased Vietnamese domestic production should be used to increase exports or to pay military costs now funded by the U.S., thereby diminishing the GVN's dependence on the U.S.

Such arguments led the VSSG analysts to finally conclude that:

-- (1) No additional U.S. dollars should be provided to increase private incomes;

-- (2) The GVN should be urged to increase real tax revenues by at least 10% per year in order to transfer income from the private sector to the public (defense) sector. (A 10% increase in tax revenues, if obtained, would lessen U.S. assistance requirements by about $10 million.)

But how would it solve the drop in urban problem

-- (2) The GVN was using U.S. assistance ineffectively. Up to $100 million in U.S. assistance accrues to selected importers who obtain GVN import licenses. Often these importers are friends or relatives of high-level GVN officials. They can import goods at the overvalued currency rate of 150 piasters per dollar, but because there are only a few of them, as "monopolists," they can sell imports purchased at 150 piasters per dollar to consumers at a higher rate (e.g. 275 piasters per dollar) and pocket the difference. These "windfall" profits would be transferred to the GVN treasury to pay war costs if the GVN devalued its overvalued currency, because the GVN, which receives dollars from the U.S. would sell them to importers at a higher price.

In short, from a possible added requirement for U.S. assistance of $200 million (to cover an increase in official wages and Vietnamization costs) can be subtracted $110 million (increased GVN taxes and a devaluation to eliminate windfall profits) resulting in an increased requirement for U.S. assistance of about $90 million.

This, in simplified terms, was the VSSG finding. Other considerations were taken into account, for example the desirability of promoting exports and reforming antiquated interest rate laws, but in terms of the total assistance requirement they are relatively unimportant. Such measures are included in the VSSG reform package (NSDM 80) mainly in order to point the GVN economy in the right direction.

The Reform Package

For the U.S. to have simply gone ahead on its own and increased its assistance by about $100 million to $750 million, as the analysis concluded, would probably have been counter-productive because:

-- (1) The GVN would have had no incentive to change its exchange rate to eliminate windfall profits and transfer them to the GVN budget as our calculations assume. Thus, had the U.S. not sought a partial devaluation, another $100 million of U.S. assistance would have been required.

-- (2) In addition to saving $100 million, a devaluation was a prerequisite to stabilization of the GVN economy. The additional $100 million in GVN piaster receipts would allow the GVN to cut its budget deficit from 30% to 15%. This deficit has been the principal cause of inflation in South Vietnam. In the last year, prices have risen 60%. A speculative psychology grips the country with importers and rice farmers holding their goods off the market in anticipation of higher prices. This adds to the scarcity of goods and sends prices up higher. These speculative pressures have fed and been fed by political unrest (for example by the veterans).

A critical aspect of the devaluation pointed up by the analysis was that, while the exchange rate needs to rise sharply (by almost 100%) for most commodities and exports, it should not be allowed to increase by the same amount for essential imports. If the import prices of essential commodities (such as rice) rose by 100% a major political crisis would result. It would be foolish to expect that official wage earners who had suffered real income losses of 25% to 50% in the last three years, pushing them to a subsistence income level, would accept a 20% wage increase with a 100% increase in the prices of essential commodities. Vietnamization and the political stability of the GVN would be jeopardized. (It was largely for this reason that the DOD proposal for a devaluationacross the board was ruled out. Risking the fall of the GVN to save $20 million doesn't make sense given the billions we are spending in Vietnam. DOD should be the first to see this, but propelled by Nutter's desire for a "pure professional solution," they opted for a potentially suicidal course.)

The Timing of the Reform

It is clearly desirable to get on with the economic reform as rapidly as possible in order to stop excessive hoarding and speculation and therby limit or end inflation.

Just as important, however, was to get GVN cooperation. After completing a paper for the VSSG, Chuck Cooper returned to Saigon in mid-July as Economic Minister. He soon obtained the GVN's acceptance of a reform package consistent with the President's guidelines as described in NSDM 80 (at Tab A). (An IMF team recommended a similar package to the GVN.)

The only outstanding issue is the date on which the reform will be implemented. President Thieu has sought Senate approval of a special law (the House has already approved) that would permit him to devalue with legislative endorsement. Thus far Thieu has failed to persuade the Senate. (You recall that last year President Thieu implemented austerity taxes on his own only to have the Supreme Court declare them unconstitutional. They were rescinded, submitted to the National Assembly and eventually approved. He paid a high political price for acting without Assembly support and is reluctant to do so again.)

<u>However, Thieu has assured the Mission that he will act in September even if he cannot obtain Senate endorsement.</u> Bob Sansom talked with Cooper last night. Cooper reported that Thieu may make one last try for an emergency session of the "old" Senate in early September to get the reform bill approved. Cooper assured Sansom that the Vietnamese are not temporizing, but intend to act by late September. Thieu wants to give the Senate one last chance to share the blame for the reform. (Thieu cannot delay much longer. Endorsement from the new Senate is not possible before November; therefore, if Thieu fails to get approval from the old Senate, he has no choice but to act on his own.)

The economic situation, while serious, does not justify intervention on our part to force Thieu to act in early September as opposed to later in the month. Ambassador Sullivan has urged such an intervention, but I think it unwise. As long as the GVN acts by the end of the month the economic problem will be manageable. I believe AID can hold Congressman Moss off for another month.

I will inform you if there is any change in this scenario.

<u>A Bad Press, A Good Antidote</u>

Two articles have appeared recently that attacked our Vietnam economic policy in inaccurate and uncompromising terms. One was by Jack Foisie in the <u>Los Angeles Times</u>, the other by Mankiewicz and Braden in the <u>Post</u> (at Tab B). The sources for these broadsides may have been recently relieved US-AID economists from Saigon or Congressional staffers.

Such stories are no help to Vietnamization and damage the prospects for continued U.S. assistance for Vietnam.

Professor Arthur Smithies, who was recently in Saigon, has written an unclassified paper on the economics of Vietnamization that could serve as an antidote to these scurrilous pieces. Smithies paper needs some tightening up which he can easily accomplish when he returns to Washington from Australia in the next week or so.

After his paper is revised, I will forward it for your review and recommend a course of action for its public release, possibly via AID and DOD.

NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

Lynn

SECRET/EXDIS

August 13, 1970

National Security Decision Memorandum 80

TO: The Secretary of State
The Secretary of Defense
The Director, Office of Management and Budget
The Administrator of the Agency for International Development

SUBJECT: Vietnam Economic Policy

The President has made the following decisions on U.S. economic policy for South Vietnam for FY 71 and beyond.

The level of U.S. foreign exchange support for Vietnam in FY 71 will be $750 million. This support will be provided so as to obtain an effective exchange rate on GVN imports that permits open import licensing at the $750 million level, i.e., the rate on non-essentials should be adjusted in order to permit open licensing on imports, thereby eliminating windfall profits and minimizing increases in the prices of essential imports.

The $750 million level will be the ceiling for U.S. assistance to Vietnam for FY 71 and beyond. It is expected that as domestic production rises and GVN exports increase, U.S. assistance will decline so as to maintain the current level of consumption.

On the basis of current budget projections (see the attached table), $740 million import funding will be available. The Department of Defense will provide the additional $10 million to meet the $750 level and the Department of Defense expenditure ceiling will be increased by the same amount. Likewise if other adjustments result in further shortfalls these will be compensated by similar increases in Department of Defense expenditures and adjustment in the Department of Defense expenditure ceiling.

SECRET/EXDIS

Note that MACV AIK expenditures will be reduced by fifty percent in order to minimize the inflationary impact of U.S. piaster expenditures for which the GVN receives no dollar compensation.

The Department of Defense should explore ways to increase on-shore procurement of items now purchased outside Vietnam as a means of increasing its dollar expenditures in South Vietnam and promoting economic development.

The U.S. will employ the assistance provided in accordance with the above guidelines to support and encourage GVN economic policies that accomplish the following:

-- promote economic growth and exports,

-- increase real domestic tax revenues by at least 10% per year,

-- insure that the sales of U.S. imported rice are conducted so as to:

-- stabilize but not depress internal rice prices and encourage increased rice production,

-- move South Vietnam to self-sufficiency in rice at world market prices as soon as practicable,

-- rationalize official sales of rice to minimize the gap between official and free market rice prices and to eliminate the corruption attendant to the present system,

-- insure that the GVN institutes a realistic accommodation rate,

-- encourage the GVN to maintain reserves at $200 million or less.

None of the foregoing policies should be pursued in a manner that would jeopardize the goals of Vietnamization or the fundamental objective of U.S. policy that the political forces within South Vietnam should determine its future. In particular, major or precipitous declines in the incomes of large income groups should be avoided, although slight declines are expected, particularly for farmers whose incomes have been greatly increased by recent price changes or urban workers who have profited from war-time economic conditions.

To provide on-going review of the foregoing policies and the economic situation in South Vietnam the President has directed that the VSSG:

-- monitor and report as appropriate on major economic developments in South Vietnam,

-- consider the adequacy of GVN civilian and military wages and the proposed GVN wage increase and possible implications of GVN wage policy for U.S. objectives,

-- develop a plan for funding in FY 72 the level of U.S. assistance required pursuant to the preceding policy.

Henry A. Kissinger

cc: The Secretary of Agriculture
The Secretary of the Treasury
The Chairman, Joint Chiefs of Staff
The Director of Central Intelligence

FY 1971 Sources of Commercial Import Financing
($ US Millions)

CIP	300
PL-480	135
U.S. Piaster Purchases	305
	740

Derivation of U.S. Piaster Purchases

Expenditures

DOD Regular	260
DOD Other 1/	50
Civil Official	50
Personal Purchases	40
	400

Sources of Piasters

AIK	20
Trust Fund	40
PL-480	25
Other	10
	95

Net U.S. Piaster Purchases $305

1/ Based on $15 million for Special Forces, $35 million for RDC.

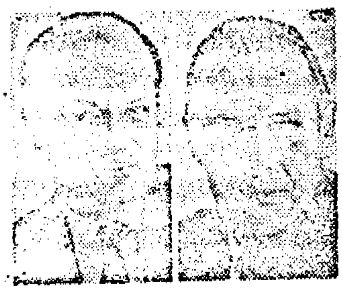
Frank Mankiewicz and Tom Braden WASH. POST 1 SEPT 70 TAB

Economic Disaster in South Vietnam

A MAJOR FAILURE of U.S. policy in Vietnam is being concealed by the Nixon administration. It is that the Saigon government is looking at an economic picture so bleak that many experts—Vietnamese as well as American—believe the Thieu-Ky government may fall well before any coalition is negotiated to take its place.

So embarrassed is our government by the evidence of the massive failure of our economic programs in Vietnam that it is restricting the evidence to a "need-to-know" level. On the very day that it was first reported in this space that a $200 million economic aid program for Cambodia was in the works—to be headed by the same man who administered the disaster in Saigon—copies of the Saigon Post, an English-language daily regularly circulated to Washington officials, was stamped "Secret" in the State Department and its circulation limited.

The newspaper reported that the price of basic commodities in Vietnam had risen by an incredible 700 per cent in the last year in the cities.



Mankiewicz Braden

Indeed one prominent Vietnamese government official said recently—in a discussion about possible alternatives to a Thieu-Ky government—that he would not take the presidency if it were offered, because the economic plight of most of the people would force any government out of office.

JUST WHY the economy is in such bad shape, is an interesting story, and one that goes far to demonstrate why a recent poll in Vietnam, commissioned by the U.S. military command, showed that only 5 per cent of those questioned wanted Americans to remain. The cause lies in two areas over which the U.S. has considerable control. We can insist on a realistic devaluation of the Vietnamese currency, the piaster, and we can eliminate the Commodity Import Program, a multi-billion dollar U.S. program that enriches the corrupt and aids the Vietcong.

First, the devaluation. The official rate is now set at 118 to the dollar. The black market rate—that is to say, the actual rate—is over 700 to the dollar. That is an enormous temptation to the GI, who must either have his pay artificially reduced or sell his dollars on the black market. It also means that U.S. dollars go from the bars and bordellos of Saigon—largely owned by the wives of Saigon's generals—to the black market, where they yield more piasters, to be converted into gold leaf to be smuggled out, or to find their way to the Vietcong to be used to buy weapons through Hong Kong or Bangkok.

OBVIOUSLY, the remedy is a devaluation. But a realistic one, which might set the official rate at, say, 600 to the dollar, would hurt not only the generals' wives but also the businessmen who are the backbone of Thieu's support as much as it would help the GI and the poor Vietnamese. What is now being discussed in Saigon and Washington is a token devaluation to something under 250 to the dollar. This might look good, but it will solve nothing.

Second the Commodity Import Program. This is the heart of our economic policy in Vietnam. It provides U.S. taxpayers' money to enable Vietnamese importers—at the official rate of exchange—to buy luxury goods, such as television sets, cars, motor scooters and automatic calculating machines, in the United States. The goods are then resold, at the actual rate of exchange, to those Vietnamese who have become wealthy enough to buy them.

But no attention—and no money—is paid to support of production of charcoal, rice, fish sauce and soft pork—the staples of the Vietnamese "Silent Majority." And as refugees come to the cities, and these goods become produced and shipped by fewer people in more difficult circumstances, their price climbs out of sight. Suppression of that news will not make it go away.

No Objection To Declassification in Full 2012/02/13 : LOC-HAK-257-1-15-9