THE EFFECTIVENESS OF CUBA'S BANKING SECTOR REFORMS

Armando S. Linde

It is a pleasure to be here this morning, to have the opportunity to speak before such a distinguished and informed audience on the subject of banking sector reforms in Cuba. I will begin my presentation with a brief survey of the Cuban financial sector before the reforms were introduced; I will then proceed to describe the steps taken in 1997 to liberalize the financial system; and I will conclude with some observations regarding the implementation of these reforms and what might be done to enhance their effectiveness.

THE FINANCIAL SYSTEM BEFORE THE REFORMS

Until about two years ago, the Cuban banking system consisted of the Banco Nacional de Cuba (BNC), which functioned as a commercial bank and bank of issue but had virtually no role influencing monetary trends in Cuba's centrally planned economy; the Banco Popular de Ahorro, essentially a savings and loan; and two other state-owned banks involved in foreign trade. In 1995, when the exchange system was liberalized, Casa de Cambios S.A. (an official exchange house wholly owned by two state entities) began operating with 23 branches throughout the island, enjoying a virtual monopoly on transactions in the parallel exchange market. The financial system also included a number of entities serving primarily as a treasury window for trade associations and providing short-term credits to these associations; and a financial company funded by time deposits from banks and state enterprises and lending also at the short end. There were also two insurance companies, one specializing in domestic casualty risk, mainly on housing; and the other providing trade freight insurance.

The Cuban financial system was therefore primitive, narrow, and dominated by the state. It played a passive role in encouraging savings and channeling these resources to productive endeavors. Interest rates were (and remain) low and were not seen as an instrument to induce shifts in liquidity preferences or as a means to accumulate wealth. There were no mechanisms to conduct open market operations, and except for a liquidity ratio, bank deposits were not subject to legal reserve requirements. In sum, macroeconomic trends were primarily influenced by the fiscal policy stance, and the banking system was almost exclusively utilized to accommodate fiscal and quasi-fiscal needs.

In Cuba's economic system, rationing, whether to limit access to credit or to the goods markets, was (and remains) the primary allocative tool to balance supply and demand. Banks basically served as depositories of excess liquidity that could not spill into prices or the balance of payments because of coercive price and exchange controls. Black markets and, since 1995, the dual currency system and the government-sanctioned parallel exchange market did provide some outlet for demand pressures arising from the monetization of fiscal deficits. Banks did serve a useful purpose in keeping the economy from falling into outright barter, and the Banco Nacional has been an important source of economic intelligence to policy makers, and a strong voice on the side of financial discipline.

THE FINANCIAL SECTOR REFORMS

In 1997, a number of steps were taken to liberalize the financial system. A new central bank, the Banco Central de Cuba (BCC), was established, removing central banking functions from the National Bank, which, with its 200 branches in turn became a commercial bank. A number of new state banks have been chartered. Branches of the government exchange houses numbered 64 by mid-1998. Fifteen foreign banks had opened representative offices by the end of last year. The government is computerizing the banking system, introducing cash dispensing machines, and modernizing the check-clearing system. The insurance industry is expanding, and new products are being promoted; namely, travel and medical insurance, and personal pensions.

Other actions under consideration or about to be undertaken include: (a) broadening the charter of the Banco Popular de Ahorro beyond its traditional savings and loan activities with families and individuals to include the provision of commercial banking services to enterprises, including a foreign exchange window; (b) the establishment of an investment bank, perhaps with private sector participation that would raise funds both domestically and in world markets and extend longer-term financing for capital projects; and (c) opening the insurance sector to foreign investors.

As regards the central bank, the legislation approved on May 28, 1997 (Decree-Law 172) creates an autonomous entity responsible for "the maintenance of monetary stability and the orderly development of the economy." Its charter entrusts the BCC with typical central bank functions, such as the preservation of the value of the currency and, accordingly, with the management of monetary, credit, and exchange rate policy, and with the function of lender of last resort. In addition, the BCC is responsible for banking supervision, and the licensing of banks and financial companies. Within 60 days of the promulgation of Decree-Law 172, the BCC was to propose draft legislation to give legal status to the new Banco Nacional de Cuba, comprising the commercial side of the old central bank/commercial bank combination. As far as I am aware, this requirement has been completed but it is not clear that action has been taken.

Reportedly, the thrust of these reforms is seen by Cuban officials as a complement to the very tentative and gradual steps that have been taken by the government, beginning in the early 1990s, aimed at relaxing government control of the economy in the face of the collapse of the former Soviet Union and the break in the political and economic ties between the two countries. As with the liberalization of the economy in general, the new legal structures that have been put in place can be characterized as a modest and measured approach toward providing a certain degree of autonomy to newly formed financial entities, allowing them to experiment with a market orientation and help foster Cuba's embryonic market economy.

Similarly, in the case of the new central bank, its charter in principle invests the BCC with the traditional tools of monetary control. In practice, however, it is highly unlikely that the BCC will be allowed to operate independently. The charter, for example, prohibits central bank financing of government deficits, but this injunction can be legally overturned by the Council of Government. Similarly, the BCC is authorized, as most central banks are, to extend rediscounts to the rest of the banking system (exceptions are countries that operate under currency boards or currency board-like arrangements, such as Argentina, Bulgaria, and Estonia). Thus, other banks can provide deficit financing to the government and in turn be supplied with liquidity by the central bank. Given the political realities—and notwithstanding that its charter technically gives the BCC a much wider array of instruments than it had in the past with which to influence Cuba's macroeconomic performance—it can be safely assumed that decisions affecting the formation of savings, the allocation of loanable funds, the price level, and the external value of the peso will likely remain in the hands of central planners for some time to come. Central planners, of course, include trusted BCC officials, and in that sense, BCC's research and policy advice can be expected to strongly influence decision-making.

BASIC PRINCIPLES FOR SAFE AND SOUND BANKING

Before turning to an assessment of the reforms of Cuba's financial system that I have just outlined, it will help to briefly review the conditions that are generally considered necessary for sound banking. Banks form the core of most financial systems and are essential to the efficient functioning of economies. Despite their importance, since the late 1970s, virtually every country in Latin America has experienced banking sector problems. Serious banking problems also have emerged in the past two years in the emerging market economies of East Asia, particularly in South Korea, Thailand, and Indonesia. These problems are now being brought under control, and an economic upturn in these countries is within sight. Industrial countries have also not been immune to the ravages of banking crises. Not that long ago, it took a lot of hardship and treasure to resolve the savings and loan crisis in the United States. Japan is only now beginning to take more determined steps to restore its banking system to health, at a substantial fiscal cost, and after almost a decade of economic stagnation.

These crises are not unrelated to the advent of a global financial system, whose rapid evolution has outpaced the adaptation of institutions and regulatory instruments. In their aftermath, a few commentators, but thankfully fewer policy makers, have shown flashes of nostalgia for an international financial system relying on capital controls. The fact is that, as the IMF's Managing Director recently put it, "the future holds a financial system based on integrated, open capital markets ..."; and he continues, "History tells us that it is foolhardy to resist progress or new innovations. Globalization is here to stay."

Globalization, which is indeed here to stay, poses a difficult challenge for the international community. It gives rise to a need for international standards of good financial behavior that can be used to follow developments that could potentially affect the world economy. The challenge for national authorities is even more formidable, as they must keep abreast of developments and innovations in the global marketplace and be in a position to quickly adapt policies and procedures to rapidly changing trends and events.

By now, there is a broad consensus on what needs to be done to strengthen financial systems. There are four basic principles for sound banking that are as applicable to Cuba today as to any other country. These are:

- One, the macroeconomic policy framework must be kept sound; in particular, monetary and fiscal policies have to be consistent with the choice of an exchange rate regime.
- Two, the domestic financial system needs to be kept strong through improved supervision and prudential standards; strict adherence to capital requirements; good asset valuation procedures; provisioning for bad loans; limits on connected lending; publishing informative financial information; and ensuring that insolvent institutions are dealt with promptly.
- Three, the central bank must be strong and independent.
- Four, timely, accurate, and comprehensive information needs to be provided to the public, so that investors can make informed decisions, markets will be less prone to herd behavior, and policy makers will have the incentive to address weaknesses in the system at an early stage.

THE EFFECTIVENESS OF BANKING SECTOR REFORMS IN CUBA

These principles of sound banking are necessary conditions for a healthy financial system, but surely are not sufficient. Virtually all of the countries facing serious banking difficulties in recent years did not lack the instruments to deal with liquidity or solvency problems in individual banks in order to prevent those problems from spreading to the rest of the banking sector. To have the means to act quickly when circumstances call for action is, of course, important. But what is critical is to be willing to unflinchingly apply sanctions when financial institutions begin to operate outside of accepted norms. Let us be clear: the goal is not to prevent all bank failures, but to have in place the regulatory and prudential norms that will help erect a firewall around individual banks, so that when troubles emerge, contagion to the rest of the financial system can be contained.

Unfortunately, as often as not, there is a reluctance on the part of the authorities to intervene or to close a financial institution, sometimes even when unmistakable signs of insolvency appear. Generally speaking, there is a tendency to postpone taking action, not only because sometimes deceptive reporting can blur the line between illiquidity and insolvency (and it takes an experienced bank supervisor, especially in borderline cases, to decide whether remedies can be applied to save a troubled bank), but also in the false hope that the problem at hand will somehow correct itself. In other cases, the problem is more pervasive, when failing banks are allowed to continue operating protected by powerful vested interests.

- **Here, then, is the first key conclusion that might be drawn for Cuba on the basis of experiences with systemic banking failures elsewhere: Even with the right tools, it takes decisive action to put them in play when the need arises.** The BCC's charter has been modeled largely after other such documents in other countries. In that sense, the charter may be only as good as the paper on which it is written—depending on whether, when the need arises, it is properly applied, including the appropriate sanctions against unsound financial practices.
- **A second important point to note is related to the Cuban government's intention to open new state banks as part of the reform process.** As I have noted, governments often find it difficult to close insolvent private banks, and even more difficult to deal with inefficient state banks. It is not unusual for these banks to continue to operate with negative net worths, thanks to the strong backing of unions and/or other politically entrenched groups that benefit from the banks' soft-loan windows. Most state banks that I have known are vastly over staffed, riddled with cronyism, and technically insolvent. These banks manage to stay afloat because of often unrestricted access to central bank rediscounts and advances, which are automatically rolled over or never repaid. In countries where the central bank enjoys the political backing that enables it to maintain a firm stand against bailouts, state banks have been known to simply resort to their deposit base to cover operating losses.

The Cuban authorities might wish to consider opening the domestic banking sector to private ownership to accompany the ongoing process of liberalizing the real side of the economy. The current official approach of deepening the financial system by creating new state entities is one that has been tried many times, in many places, often with the best intentions, but always with disastrous results. State banks are but extensions of the government, little more than outlets for extra-budgetary spending. But when serious problems emerge and depositors take flight, the cost of recapitalizing these banks to cover the accumulation of losses and write-offs of nonperforming loans must suddenly be borne by the central bank through a possibly inflationary bailout (in the event of a run on deposits) or by government assumption of debts and/or borrowing. In both cases, budgets are burdened for years to come, and the damage to the economy in terms of output and income foregone is permanent.

The foregoing suggests that Cuban officials may wish to reflect on heeding the advice of those policy makers in all parts of the world who have had to wrestle with the cleanup of state banks or private banks closely connected with the government. That advise would go something like this: Governments do not make good loan officers and should stay away from the banking business; bring in private banks, which will surely help themselves at the profit table, but if properly regulated, supervised, and taxed, will provide an invaluable service to the economy.

- **A third observation that seems appropriate for a country entering a process of financial sector reform is to draw lessons from the implications for emerging market economies of the coming of age of global financial markets.** Important as the trend of globalization has been to developing countries, providing them with access to large pools of capital, enabling them to adapt and modernize their productive base and maintain their competitive position in the face of rapid technological change, globalization and the attendant financial innovations have made the work of bank regulators and supervisors all the more difficult. Market participants will always be changing and innovating, and testing the limits of legality and prudence. Regulators and supervisors will always be a few steps behind, trying to adapt rules and supervisory procedures to the latest financial products and developments in financial markets. At the same time, other market participants will often have insights that supervisors may lack. Supervision and regulation must therefore work alongside and operate on the premise that prolonged supervisory forbearance will create incentives for imprudent banking practices. Only through constant exposure to these tensions between the supervisors and the supervised can the monetary authorities and bank regulators gain the necessary experience to keep abreast of market innovations. In Cuba's closed system, the BCC will be hard pressed to find or train a team of independent bank examiners who understand banking and business risk and who could, in effect, make sound loans themselves because they understand the process. This expertise can only be developed over time in the context of an adversarial relationship with profit-oriented bankers, and it will not come about through audits of state banks likely to be conducted at less than arm's length.

- **Fourth, it is difficult to envision how Cuba's banking sector will evolve and prosper in the absence of the legal and judicial infrastructure needed to maintain the credit discipline that is so essential for banks to function properly.** The combination of a state-dominated banking system and the lack of judicial instruments and venues to enforce contracts and credit instruments makes for a combustible mix.

- **A fifth and final note relates to the issue of openness and transparency and adherence to international standards.** It would seem a fairly straightforward proposition that, if at some point, Cuba aims at rejoining the world financial community, it will want to abide by the rules that govern international financial transactions. One of the principal reasons that banks fail is a lack of transparency about their operations and financial condition, which makes it difficult for market participants and bank supervisors to distinguish the weak institutions from the strong. In many countries—developing and industrial alike—loan valuation and provisioning standards are not rigorous enough to prevent banks from concealing the full extent of nonperforming loans. In this connection, principles and standards like those of the Basle Committee serve as a useful reference point for the dissemination of best banking practices. These standards are not meant to be blueprints applicable to all countries, and they need to be interpreted and adapted to local conditions, but they are a useful starting point. It is not at all clear that Cuban officials have yet begun to deal with these issues.

In conclusion, the Cuban government has taken a cautious first step to liberalize the banking system. The new central bank has been given the traditional instruments of monetary control and, in principle, autonomy to preserve the value of the currency and create an environment for stable growth. This is a positive development. As regards the rest of the banking system, the creation of new official financial entities is a singularly bad idea, one that the authorities will live to regret. In general, an enormous amount of work remains to be done, including revamping the judicial system, if Cuba wishes to have a state-of-the-art banking sector. Cuba has the advantage of drawing lessons from banking crises in other countries and avoiding the mistakes made. It remains to be seen whether the government has the political desire to move more rapidly and more comprehensively in implementing banking sector reforms. So far, there are no signs that the government is truly committed to undertake meaningful reforms in the Cuban banking sector.