

COMMENTS AND OBSERVATIONS ON THE U.S. INTERNATIONAL TRADE COMMISSION REPORT

Gary H. Maybarduk¹

I congratulate Jonathan Coleman and the other authors of this study. This work is must reading for anyone interested in the Cuban economy. It convincingly estimates the economic impact of the economic embargo on the U.S. and Cuban trade. It also provides a useful history of the embargo, considerable information on the development of the Cuban economy, and a valuable sector-by-sector review of that economy. Given the impressive reach of this study and the care the authors took in reaching their conclusions, I will limit my comments to some supporting observations and to some related issues that were beyond the Commission's mandate.

The authors of the study used a gravity model to estimate the potential share of total Cuban trade that would flow to the U.S. with the lifting of sanctions. As a base, they used data on Cuba's average annual trade with the world during 1996-98.² In the absence of sanctions, the Commission estimated that yearly U.S. exports to Cuba would range between \$658 million and \$1.0 billion. Assuming resumed telecommunications payments, additional travel and tourism income, and U.S. foreign direct investment, the upper limit of the export estimates rises to \$1.2

billion.³ Adjusting for population, the U.S. per capita exports to Cuba would range between \$2.30 to \$4.20.⁴

As a check of the authors' methodology, I made my own estimate using a much less sophisticated back-of-the-envelope method. According to the Cuban Central Bank, total Cuban imports in 1999 were 4.3 billion dollars.⁵ For the past four years, imports have averaged about four billion dollars and have been growing at about 6.3 percent per year. We can subtract Cuban imports of petroleum derivatives during that period and value them with perhaps an average price of \$15/bbl (it would be much higher today) or about 500 million dollars per year. That leaves a potential market for American products of about 3.8 billion dollars. Drawing from the example of a nearby reasonably open economy with strong commercial American penetration, Venezuela, we assume the United States would provide 40 percent of the remaining imports. These calculations provide an estimated \$1.52 billion of U.S. exports to Cuba.

Total U.S. exports in 1999 totaled \$990 billion. Projected Cuban imports from the U.S. would therefore

1. The contents of this paper are the sole responsibility of the author and do not necessarily represent the views of the United States Government or the Department of State.

2. *The Economic Impact of U.S. Sanctions With Respect to Cuba* (Washington, DC: U.S. International Trade Commission, February 2001), p. 1-2.

3. *Ibid.*, p. xiv.

4. Based on a population estimate of approximately 285,436,000 (U.S. Census Bureau's internet site, October 27, 2001).

5. *Informe Económico de 1999* (Havana: Banco Central de Cuba, 2000).

be only 0.15 percent of total U.S. exports or \$5.33 per person. This is somewhat higher than the Commission's estimate and would be even higher if I incorporated the other assumptions included in the Commission's highest estimate. The two results, however, are very close. They lead to a robust conclusion that the increased trade flows from lifting the sanctions would be very small and have little impact on most Americans.

In actuality, the increase in economic welfare to the average American is likely to be even smaller than the estimates above. The increased economic welfare to the American economy cannot be measured by the increased exports to Cuba.⁶ The appropriate measure is the increased revenue to factors of production resulting from the development of the new market. The Commission does not attempt to make this adjustment, presumably because it would require separate estimates for each industry and substantially increase the study's complexity. Nevertheless, the principle is evident in their discussions of various industries, where they observe that the impact of sanctions on most sectors of the American economy was very small because alternative markets were quickly found.⁷ The reverse is also true. To export to new markets in Cuba requires moving resources from other markets.⁸ Of course, some individual exporters may benefit. However, the extra return to a sector, or to the economy as a whole, is likely to be much smaller than the value of exports, especially with the

U.S. economy at full-employment. The actual benefit therefore would only be a small fraction of the estimated \$4.20 or \$5.33 per person.

CREDIT

The Commission was not tasked to comment on the issue of credit and therefore only touches on its importance.⁹ Nevertheless, the issue of credit is essential to the viability of trade with Cuba and, of course, has been an important issue in Congress. The annual report of the Cuban Central Bank reports that eighty percent of Cuban imports in 1999 were financed by credit, seventy percent short-term.¹⁰ Although the level of Cuba's foreign exchange reserves is not publicly known, it is unlikely that Cuba has the ability to make large cash purchases. Because of Cuba's chronic payment difficulties much of Cuban trade is, in fact, something close to barter. For many years, Cuba and the Soviet Union engaged in the direct barter of Cuban sugar for Russian oil. More recently, Cuba and Russia have used European trading firms as intermediaries to serve the same function, presumably because Russia is moving out of barter trade and does not want to take the risk of Cuban non-delivery. Although the deals lack transparency, the firms reportedly provide oil, sugar production inputs, and other needed commodities such as rice. In exchange, they buy the harvested sugar.¹¹ To cover their risk, the firms pay a price below market price for the sugar and charge a premium for the inputs. The trading firm also tries to hold a claim on the export item.¹²

6. This is not a criticism of the Commission, which is careful not to put its results in terms of economic welfare. That would be a much more ambitious task and was unnecessary given that their results showed only a small increase in U.S. exports.

7. Those studies are summarized in *The Economic Impact of U.S. Sanctions With Respect to Cuba*, pp. xv-xxiv. The impact on each individual sector is likely to be greater than on the economy as a whole, since most factors of production can move between industries.

8. A variation of this argument applies to the tourist industry. The Commission reports various industry estimates of a substantial increase in tourism to Cuba with the lifting of sanctions, as well as the concern of Puerto Rico's tourist industry over diverted travel (Ibid., pp. 4-21-4-22). However, unless the tourism associated with the lifting of sanctions comes from those who would not have otherwise traveled, the new Cuban tourism will likely come at the expense of travel within the US or to other Caribbean locations. The gain to the American travel business may well be minimal. The greatest return will be to American tourists, who will have a greater consumer choice of locations.

9. Ibid., p. 1-18. Nevertheless, the Commission's short comment covers much of the issue by pointing out that credit will be needed and that it might become a cost for the U.S. Government and taxpayers.

10. *Informe Económico de 1999* (Havana: Banco Central de Cuba, 2000).

11. Presumably, the need for these agreements has declined significantly since the 2001 Cuban-Venezuelan oil agreement.

12. If the embargo is lifted, but controls on credit remain, there will be a need to define "credit," including the practices described above.

Before the passage of the Helms-Burton Act, European banks financed some of this trade. They also tried to minimize their risk by loaning directly against the expected export receipts of specific commodities. As in the case of the trading companies, the banks took the risk that Cuba would be unable to deliver the expected quantity of the commodity.

Since Cuba's economic opening, which followed the withdrawal of Soviet assistance, Cuba has also received trade credits from foreign governments. This money appears to be more politically than economically motivated, as governments have sought to subsidize their own country's exports or make a political statement. Governments are already finding that collecting on these credits is problematic. The UK, Belgium, Japan, Italy and Germany are among the countries that have had to reschedule their short-term credits or lend new money to Cuba to ensure their exporters were paid.

Not just governments have had trouble collecting their debts. The Cuban Government appears to try to meet its debts to large suppliers with whom it needs to maintain regular commerce. It does not always accord the same treatment to the smaller supplier. During my two years in Cuba, several European commercial attachés reported that it is a common practice for Cuban firms to order a container or two of basic commodities on credit. The small exporter provides the credit, hoping the transaction will lead to larger sales. All too often, however, the vendor is not paid and the Cuban firm simply finds another small trading partner with whom they repeat the operation.

The bottom line, therefore, is that if one expects to obtain significant trade with Cuba, credit from some source—governments, banks, or the supplier—will be necessary.¹³ At the same time, the danger of default on that credit will be high and on a net basis could easily overcome any gains from trade.¹⁴

THE DYNAMIC ELEMENT

The Commission's work is essentially a static study. Underlying its results is an assumption that Cuba's own economic policy is unlikely to change with the removal of sanctions. I believe that assumption is correct. Nevertheless, it is worth commenting on some potential changes that will follow a lifting of the embargo.

Investment

If trade is not likely to bring much benefit to the American economy, would investment? The Commission's attempt to review the investment situation was hampered by the lack of data. Nevertheless, the study provides a good overview of the formal investment regime and some of the problems.¹⁵

There is no doubt that the economic needs are considerable in Cuba. With an open investment regime and a free market economy, the potential for investment, both domestic and foreign, would be tremendous. Those conditions do not hold, however, and are unlikely to do so under the current Cuban government.

Since the Cuban government began to accept foreign investment in the early 1990s, there has been relatively little foreign investment.¹⁶ This is not for a lack of interest. The study reports that, "Foreign investors

13. To the extent the credit comes from private non-guaranteed sources, the interest rate—stated or implicit—is likely to be very high to cover the expected default risk. During the author's stay in Cuba (1997-99), bankers and businessmen reported they charged 15-24 percent interest. One banker summarized the situation succinctly by observing that once lent, money never leaves Cuba. The lender's only hope is that he continues to receive the high interest rates. That, of course, is not a bad outcome for the lender who continues to receive his payments. Nevertheless, the anecdotal evidence is that some official lenders or guarantors and many small businessmen have not been so lucky.

14. Given a continued ban on credit the trade estimates made by the Commission would have to be substantially reduced. My own guess is that the gain in economic welfare would be reduced to pennies, but this would require a much more comprehensive study to verify.

15. Ibid. pp. 3-18 to 3-24.

16. The Commission quotes a secondary source that estimates cumulative foreign investment from 1990 to 1999 at \$2 billion. See Pascal Fletcher, "Havana Seeks to Soothe Foreign Investors Over Property Measure," *Financial Times*, July 18, 2000.

complain that Cuba's approval process is time consuming and involves numerous bureaucratic hurdles."¹⁷ When I was serving in Cuba, the commercial attaché of a large Western embassy told me that his office had the third largest number of businessmen looking for investment opportunities. Only their offices in Los Angeles and Buenos Aires had more. He observed, however, that almost nothing came out of these visits. Virtually every other foreign diplomat who covered the Cuban economy made similar observations. Foreign businessmen also told the same story. Many had spent several years trying to establish ventures. They were never told no, but nothing ever happened.¹⁸

The Government's priorities and desire for control limit investment opportunities in Cuba. Cuban officials want investment in a few perceived strategic areas—mining and petroleum, energy generation, telecommunications and tourism. In the minds of Cuba's central planners, these industries generate or save foreign exchange and their social impact on the rest of society can be limited. They require relatively few employees or can be located far away from population centers.¹⁹

Tourism

The tourism industry is one area generally believed to be a lost opportunity for American firms. Statistics on foreign investment and profitability are not available. Based on anecdotal information I collected during my two years in Cuba, my impression is that the

tourist industry has been only marginally profitable for most investors. Industry sources reported the first hotel with substantial foreign ownership, a Meliá Hotel in Varadero, recouped its investment in four years. Since then, however, several foreign hotel managers have reported that increased competition and high operating costs have reduced profit margins considerably.

Most of the large European corporations that invest in the Cuban tourism industry try to keep their investment to a minimum. Generally they only invest as little an amount as they can negotiate, 5-20 percent, plus a loan they may make to the Cuban government to finance the Government's share. Smaller foreign investors then sometimes make up the rest. The large hotel chains do not make most of their money on hotel services, but rather on the package tours their parent companies put together. According to several managers, the real reason to locate in Cuba today is to be in position for the end of the embargo and the expected rush of American tourists that would follow. In this, I believe they are correct.²⁰ There will be substantial windfall profits for the already existing hotels and their owners—the Cuban government and the European investors. Those who invest after lifting of sanctions, however, will have to negotiate with a Cuban Government quite prepared to take all the economic rent. There will be no windfall profits for the new investors, regardless of nationality.

17. Ibid. p.3-22, quoting Government of Canada, Ministry of Foreign Affairs, Cuba: A Guide for Canadian Business, 25.

18. One multinational company had a small investment in Cuba and had hoped to make a sizable new one. Its market was both the Cuban consumer and the tourist trade and it had formed a joint corporation with the Cuban government as a partner. The Cuban government usually requires joint ownership. Just before I left Cuba, in late 1999, the multinational's negotiations with the government had broken down. Its director was convinced that the Cuban government had never been serious about the investment, but rather was trying to steal the company's technology. In the meantime, the company's Cuban directors had passed the company's business plan to the wholly-government-owned Cuban competition.

19. This is even true for foreign investment in tourism. Cuban officials have clearly decided that tourism will be the basis for much of Cuba's future economic growth. At the same time, however, they have tried to isolate the bulk of the tourists from the Cuban population. This tourist apartheid is evident in the development of most of the principal tourist resorts around Varadero and other isolated places. In these locations the Cuban population is small, and it is relatively easy to prevent Cubans from visiting the hotels and beaches. In general these resorts and their environs are off limits to all Cubans except the employees who service the facilities. Even in Havana, where there has been some attempt to increase tourist facilities, local citizens are discouraged or barred from the hotels, bars, beaches, and the marinas that serve tourists.

20. The Commission reports numerous complaints with the quality of service provided by the tourist industry and the low return rate. Even so, Americans' curiosity with the once "forbidden" Cuba is likely to generate a considerable tourist flow to the island.

LOST OPPORTUNITIES

One of the arguments for the lifting of the embargo today is that failure to do so will leave American firms out of some future opening. There is no doubt that some day there will be major investment and trade opportunities in Cuba. With almost 11 million people, tremendous tourist appeal, a completely undeveloped commercial sector, and a proximity to the U.S. market, the potential is considerable.

That said, it is easy to overestimate the potential of Cuba's economic recovery. If the transition were to come suddenly today, Cuba will look more like Russia than Poland or the success stories of Eastern Europe. There will be opportunities, but the chaos caused by disputed land titles, a devastated and unprepared agricultural sector, and inefficient state industries will make doing business in Cuba difficult for some time.²¹

At the same time, these very difficulties will leave opportunities for tomorrow's investors. Foreign investment in infrastructure is still almost negligible. The electrical generation system will probably require rebuilding despite the patchwork reconstruction now underway. The transportation sector is underdeveloped. There is virtually no organized service industry and the few state-owned retail firms that exist will quickly disappear when faced with real competition. Virtually the entire housing stock needs major renovation or replacement. A few foreign firms such as Nestlé and the Japanese automobile companies have

received some brand recognition. However, since the overwhelming majority of Cuban consumers barely have the income to purchase the basic necessities, these few firms have little ability to build any true brand loyalty.

Anyone who visits Cuba quickly finds that most Cubans are intensely interested in American consumer products. The truth is that the embargo and the continuing effort of the Cuban government to blame all its problems on the embargo have created an almost mystical aura about American products. When the Cuban market truly opens—accompanied by sound economic policies that give its consumers some real purchasing power—the market will be wide open for American firms.

SUMMING UP

The above comments and observations notwithstanding, the Commission's study is an impressive and important work. The authors compiled and analyzed an enormous amount of information and material in a relatively short period. Their work belongs on the reference shelf of anyone studying the Cuban economy. At the same time, the Commission achieved its goal of making a very credible estimate of the impact of sanctions on U.S.-Cuban bilateral trade. There are many credible arguments on both sides of the sanctions debate. The Commission's study demonstrates that the sanctions' adverse impact on the American economy is not one of them.

21. See Gary H. Maybarduk, "The Post Fidel Transition: Mitigating the Inevitable Disaster," in this volume.