

## CUBA'S CURRENCY UNIFICATION: STEP-BY-STEP AND TENSIONS

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Cuba's reforms and changes aiming at a complete re-design of its rigid, state-controlled, socialist economic development strategy has come to its point of no return; there's no turning back. The Achilles' heel of this present stage is to put an end to the two-tier currency system, with all its aberrations in the fields of finance, accountability, incentives, productivity, and social differences.

Although it was announced in the Party's Guidelines (Lineamientos) in 2011, it was only in October of 2013 that an announcement was made indicating the existence of a chronogram or timeline (without details or specific dates disclosed up to now) aimed at ending this currency duality. A clear statement about the priority of such action has been made in the sense that government officials have stated that it is "imperative to guarantee the re-establishment of the Cuban peso's value and its role as money, that is as a unit of accounting, means of payment and savings" (Granma, 22/10/2013). A debate is taking place among academics and observers on this important matter.

According to David Brunat's analysis, "Unifying the currency is probably the most sensitive subject that Cuban lawmakers are to face in the economic sector in the coming years."<sup>1</sup>

### STEP-BY-STEP: A HOST OF COMPLICATED REASONS

Any discussion on unifying the currency system, must bear in mind two different contexts.

One, is the current state of the Cuban economy, including the legacy of the past, and in particular the last 20 years, due to the economic policies adopted by the Cuban government to try to deal with the monumental crisis derived from the downfall of Soviet-style socialism in Eastern Europe and the Soviet Union.

A partial and low-level recovery has taken place, with average GDP growth of less than 3% growth per annum compared to the unanimous criterion that no less than 5–7% GDP annual growth rate is needed.

Ample criticism of such legacy and of the many negative consequences that are still being felt throughout the Cuban economy, can be found across the board, but regardless of all the objections, one conclusion about those policies and actions, remains very valid: "... it avoided sending thousands of families to absolute poverty.... The cost of the crisis was thus distributed among state employees; it was the alternative to massive unemployment and sending thousands of families to absolute poverty."<sup>2</sup>

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1. David Brunat, "Cuba Currency Unification Could be Ready in 3 Years—And Then What?," *The Corner* (October 23, 2013).

2. Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva, "La reforma monetaria en Cuba hasta el 2016: entre gradualidad y 'big bang,'" paper presented at a conference sponsored by the Brookings Institution, Centro de Investigaciones de la Economía Mundial, Centro de Estudios de la Economía Cubana, and Universidad de La Habana, December 2013.

In that legacy of the past, a few structural issues that have not been dealt with so far deserve special attention due to the way in which they are intertwined with ending duality:

- There is a huge problem with the almost three thousands industrial and services enterprises (representing almost three quarters of Cuba's industrial base and some 2 million workers) that were not profitable in the 1960s, in the 1980s and are not today for a host of different reasons. These industrial and services enterprises continue to be subsidized, with damaging impact on finance, salaries, declining output, a stagnant GDP, etc.
- This industrial/services burden is—for the most part—operating with pre-1959 or Soviet era machinery and tools, and incapable thus of meeting their production goals or their financial obligations without subsidies and credits.
- These industries and services enterprises are the principal source of almost all the defaults and losses, causing major deficits and disruptions in their relations with other state companies and the national banking system, and promoting corruption. It is common knowledge that, "Cuban economists say one of the most complicated parts of the unification process will be determining the real value of state-owned enterprises and adjusting accounting systems."<sup>3</sup>
- Out of those industries and services, 941 have been identified by the Cuban leadership as "highly vulnerable" due to the high degree of extended corruption inside of them, where daily scams, theft, and robbery, take place. The meat and dairy industries, construction materials industries, warehouses, transport, food-producing industries, and restaurants are among the many involved. Ulises Guilarte, General Secretary of Cuba's Confederation of Labor and Vice President of the Council of State, is one among many Cuban leaders and economists who insist on the

crucial importance of building a network of wholesale markets to provide the growing "non-state" sectors of the economy an effective remedy to very high levels of corruption.<sup>4</sup> So far, proposals in this field coming from Brazilian and Chinese companies are still waiting for a Cuban response.

- The Cuban leadership insists in the need of an increased productivity to have better salaries and a stronger economy. Is productivity conceivable within the circumstances previously described? Not even a wizard or an act of magic, can bring about productivity in such a context. The term productivity is limited today to less than one thousand state industries and services, most of them associated through JVs and mixed capital associations with foreign investors and agriculture to the private and cooperative sectors, something that is extremely eloquent in itself.

Are there solutions to the problems mentioned above? To start with, the Party Guidelines are very clear: entities that do not meet the standards will be closed down. And if they don't want to be too drastic, they can have a few firesales, turn them over as cooperatives, break them down into small workshops. Would this be too unusual by Cuban standards? Not at all. It was done 12 years ago with more than three quarters of the existing sugar mills.

Ending currency duality in Cuba is not just an issue of one currency, of devaluation, of salaries, fiscal deficit, banking relations, accounting, GDP growth, and other similar operations. Without tackling effectively what we have discussed thus far, the monetary situation will remain extremely vulnerable. This is one of the true black holes in Cuban economics, not of a monetary issue but of a structural nature. As economist Pavel Vidal Alejandro—who specializes in monetary policies—has commented. "The dual currency system is not responsible for the low purchasing power of wages or for inequality...these are both structural, not monetary problems."<sup>5</sup>

3. Portia Siegelbaum, "Cuba announces plans to unify its two-currency system," CBS news, October 22, 2013.

4. Interview with Ulises Guilarte, Bohemia, April 2014.

5. Patricia Grogg, "Cuba's Dual Currency System: A Death Foretold," Inter Press Service, October 2013.

The second context to discuss involves the dynamics of reforms and change toward a mixed economy. Some points here deserve special attention due to their importance to make the unification process more effective, faster, and less traumatic:

- The world of microfinance and banking credit have expanded to small private businesses, agricultural and non-agricultural cooperatives, and private farmers. Although it has already started to work, it must be pointed out the modest numbers and results (close to 100 million dollars made available to some 300 000 customers) as well as the non-productive nature of most of such credits (construction, house improvement, and some services).
- A major thrust is imperative in this field. Completely redesigning an economy from almost absolute state control, will have to rely extensively on a much extended network of small- and medium-size industries and services, cooperative and private as well, that should not be excluded from interacting with foreign investors and have direct access to exports and imports, something that is also valid for many state enterprises. A senseless example is the following: If a state manager is looking for a hard-currency credit to buy a machine to produce crackers for the tourist industry that may cost \$50,000, he can't ask directly a Cuban bank for it. Meanwhile, the tourist industry is spending more than a million dollars a year in importing crackers for the tourism industry.<sup>6</sup>
- The radical redesign of the agricultural sector, although it has advanced considerably, is still limited by the survival of certain policies and mechanisms of Acopio (forced procurement), something that needs to come to an end due to the many obstacles it creates to free marketing. (Note: In July 2014, at the summer session of the National Assembly, the abolition of the Acopios was officially announced.) Another factor limiting the potential of this new agricultural setting is the lack of access to wholesale supplies, machinery, tools, fertilizers, and fuel.
- Other major actions such as a salary reform (extending and improving the steps taken more recently with Public Health/Sports personnel), additions and corrections to the current taxation legislation, reform of prices, an entirely new accounting system, and other bits and pieces of the unification process are still very much pending. Taxation policies, in particular, must provide consistent incentives and not just favor cooperatives or foreign investors. The TCP (Trabajadores por Cuenta Propia; self-employed and private sector) are not supposed to be choked through taxation but receive identical incentives as the cooperative sector, contrary to what certain officials have stated. In agriculture, with Decree-Law 300, it was clearly proven how wrong it was to exclude private farmers and finqueros, something which had to be corrected by law very recently.
- At the level of the national economy, one of the most positive results of recent policies is that since 2007, “the deficit on current account of the balance of payments was reduced, the fiscal deficit went back to approximately 3% of the GDP, and the banking crisis was solved,”<sup>7</sup> together with lower inflation compared to the 1990s.<sup>8</sup>
- Reforms in the external sector, such as the new Migration Law, legislation outlining the legal framework for Mariel’s Special Development Zone (ZEDM), and the new Foreign Investment Law, are bound to play a very positive role in their interactions with the unification process, but they are still at a very early stage to discuss how successful and influential they will become.
- Also in connection with the external sector, Cuba has been successful in renegotiating its large external debt with its biggest creditors, such as Russia and Japan, together with other coun-

6. This example was provided by Guilarte in his interview in the April 2014 issue of Bohemia.

7. Vidal Alejandro and Pérez Villanueva, Brookings Institution presentation, op. cit.

8. Ibid.

tries (including an important postponement with China). These agreements “helped Raúl Castro restructure Cuba’s active and commercial debt”;<sup>9</sup> demarches are underway with the Paris Club, exploring some forms and ways to trade debt for investments. At the same time, the temporary “freeze” or moratorium on foreign accounts in Cuban banks needed because of the 2008–2009 world recession has been lifted, with operations back to normal and fully compensated. As never before in 55 years, Cuba’s hard currency reserves have modestly increased. For the first time, Cuba negotiated a “buy-out deal” with Italian telecom STET, and paid in full for STET’s share in ETECSA, a negotiation that was carried out in accordance with international standards and deemed satisfactory by the Italian counterparts, becoming thus a sound example for future investors.

But large areas of the external sector like the huge imbalances between growing imports and very limited exports (e.g., trade with Brazil is almost 700 million dollars, out of which 600 million are Brazilian exports); its impact on the balance of payments, growing deficit, considerable obligations to meet the re-scheduling of Cuba’s foreign debt, the “parity fiction” with the dollar, and exchange rates that deny any notion of incentives to exports, investors, and tourists, all of which bounce back to undermine the value of any currency adopted by Cuba.

### FOREIGN EXPERIENCES

Many experts and observers may use the Chinese experience as a comparative case, but there are two sets of differences to bear in mind. One is that China operates in an entirely different historical context from that of Cuba; the other one, is that in China a two-currency system existed between 1978 and 1994 with a highly divergent system of exchange rates. Within this time frame, the Chinese conducted their reform

process in two different stages: 1978–1984 and 1984–1993.

During the first period of reform, three main transformations took place: privatization of agriculture, opening to foreign direct investments plus special development zones, and the promotion of private non-agricultural start-ups; during the second period, a wave of privatization of industries and services took place, prices and regulations were liberalized, and state property was limited to key state monopolies together with a two exchange rate systems. By 2005, 70% of China’s GDP was generated by the private sector.

Only then did China start its currency unification process, that is, at the culmination of its reform and redesign process along with an extraordinary two-digit economic growth. Cuba, instead, starts its currency unification when its reform and redesign process is just beginning. The Cuban experience will have to develop along three parallel lines: (a) doing away with all the dysfunctional and outdated institutions, policies, and mechanisms from the 1980s and 1990s; (b) moving forward in the implementation of the reforms already adopted and proceed to the many others that are still pending; and (c) tackling the currency unification, which will act as an effective detonator to push forward (a) and (b).

### THE CASE FOR GRADUALISM

This is the reason why ending currency duality will not come out of the blue, overnight, in one single piece of legislation to be enforced the next day or “Day Zero,” as suggested by some journalists;<sup>10</sup> nor can it take place in the course of 2014 by way of “carefully orchestrated trimesters.”<sup>11</sup> Reports from the BBC indicating 18 months for its implementation are not realistic at all.<sup>12</sup> Tom Cleveland, analyst for Forextraders.com, may be closer to the mark,

9. “The Voice of the Market,” *World Finance*, November 2013.

10. Rosa Tania Valdés, “Cubans fret as government prepares currency unification,” *Reuters*, March 17, 2014.

11. Emilio Morales, “Cuba: Doors to Monetary Unification,” *The Havana Consulting Group*, November 2013.

12. *BBC News, Latin America and the Caribbean*, October 22, 2013.

when predicting that, “the dual-currency system will take years to resolve.”<sup>13</sup>

The complexities involved are too many to be met with short-term solutions. But the process cannot wait any longer. As pointed out by Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva, “Unfortunately, the nation will have to face this complex process of monetary unification without the assistance of international financial institutions, with very limited international reserves, and at a time of low economic growth. Nevertheless, we cannot go on waiting for ‘the ideal moment’ to implement it; the structural reforms are in need of the monetary reform.”<sup>14</sup>

And this is the reason why several well-known economists (Vidal Alejandro, Pérez Villanueva, Brunat, Morales, and others) have insisted on the notion of gradualism in implementing the unification process. Cuban leaders similarly have insisted on a gradual pace whose unfolding is taking place following “the Cuban style,” meaning experiment with specific cases and areas, assess results, make corrections, and move ahead slower or faster depending upon such results. A few examples suggest the pattern that is already being followed:

- Free market sales from farmers and cooperatives to hotels and restaurants are already operating with an exchange rate that started at 7CUP:1USD and then to 10CPU:1USD.
- A host of state businesses—regardless of their subordination to certain ministries and independently from them—are conducting their transactions with other state entities and the Central Bank on an exchange rate based on 10CUP:1USD or 5CUP:1USD.
- Sugar agribusiness is currently working with three different scales: 12CUP:1USD for exports; 7CUP:1USD for imports; and 4CUP:1USD for oil purchases from Venezuela.

- Transport cooperatives are working with an exchange rate of 10CUP:1USD.
- In the field of salaries, the experiences of the ZEDM, sports professionals (players and technicians alike), and public health personnel, have signaled some of the policies to be put in place.
- Opening hard-currency stores to the use of CUP is another important signal. The cases of two of the most important of such stores in Havana, La Copa and La Puntilla, which are now selling by way of two different currencies (CUC and CUP), is also a clear indication that the unification process has started following a pattern of gradualism.

World Finance extends the benefit of the doubt to the Cuban approach to end duality: “The complete unification of the two currencies is many months, maybe years, away from being fully achieved, but it could well be the policy that defines Raúl Castro’s legacy as the reformer of Cuba (...) by promoting prudent and timely economic reforms—which Fidel was so reluctant to do—the younger brother will have carved an even bigger name for himself in modern Cuban history.”<sup>15</sup>

This step-by-step, experimenting, correcting, improving, course of action is to continue, although many other steps and actions have not yet surfaced while many questions still remain unanswered. For Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva as well as for many other experts, devaluation is the backbone of the unification process and, quite obviously, entails numerous risks and complications. How will the devaluation policies be implemented? How will the balances of the saving accounts in CUP or CUC and foreign currencies will be affected? How will this affect foreign investors and their holdings?

The Economist highlights some the potential answers to such questions, and others, in the following terms: “Unifying the currencies also ends a bizarre anomaly in Cuban accounting, whereby state compa-

13. Retrieved from CubaStandard, June 25, 2012.

14. Vidal Alejandro and Pérez Villanueva, Brookings Institution presentation, op. cit.

15. World Finance, January 21, 2014.

nies pretend in their balance sheets and domestic trading books that one CUP equals one CUC. The practice has prevented CUP inflation. But it has made imports seem artificially cheap and exports unprofitable. It also obfuscated inefficiencies that plague Cuba's predominantly state-owned businesses. Ending the charade could have dire consequences for many firms."<sup>16</sup>

Indeed a complicated host of reasons that make the step-by-step policy more than justified.

### TENSIONS

In opposition to a gradual process, there are those experts and observers that see, and suggest, as inevitable the adoption of "shock therapy" policies in which — as argued by IMF expert Rafael Romeu — "many social services would have to be eliminated."<sup>17</sup> Even Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva, who support gradualism, when discussing devaluations, suggest some sort of necessary "big bang." In a more recent statement, Pavel Vidal Alejandro has stated that, "The elimination of the dual currency, which is based on a devaluation, means there will be an initial shock..."<sup>18</sup>

From another perspective, *The Economist* states that, "The Cuban government has declared that the transition will not hurt holders of either currency. Cubans, though, are understandably wary." And then points out at another ripple effect: "Any increase in the value of the unified peso would increase their spending power. This could stoke inflation and lead to widespread shortages. The concomitant fall in the value of the CUC, meanwhile, would be fiercely resisted by those with savings in the harder currency."<sup>19</sup> Expert Tom Cleveland made a similar assessment earlier, analyzing that, "If the 24:1 ratio were changed immediately to parity, the demand for CUC-priced goods would skyrocket and inflation

would send all prices soaring. Dissolving the old dual-currency system is not easy."

But despite such apocalyptic visions and suggestions, whatever the policies to be followed by the Cuban leadership from now on, there are certain pillars of the Cuban model that will not be jeopardized or questioned: (a) "shock therapy" or "big bang" is not an option; (b) no more egalitarian practices or designs will be put in place; (c) no one will suffer destitution; and (d) the most important social programs will not be eliminated.

The notion of "shock therapy" or "big bang" is seriously cautioned by even those who suggest this possibility. Emilio Morales, who is not precisely in friendly terms with the Cuban government, stresses that, "Shifting to a single currency cannot turn into a sort of 'shock therapy' if political suicide is to be avoided."<sup>20</sup>

Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva, despite their repeated emphasis on "big bang" devaluations and initial "shocks," point to the need that, "Whatever strategies are put in place to end monetary duality, devalue, and achieve convergence of the different exchange rates, compensatory measures will be required for state businesses and families affected..." Furthermore, they stress the notion that, "Economic authorities will have to avoid an inflationary spiral" by way of subsidizing retail markets and "lessen, though not to eliminate entirely, the effects of devaluation."<sup>21</sup>

The Cuban leadership and its economic team, are very much aware of the costs and benefits of every single step of the process. They have studied carefully, in China and Cuba, the Chinese experience to see whatever may be valid for Cuba (they have paid less attention to the Vietnamese experience because of

16. "Cuba's currency: double trouble," *The Economist*, October 23, 2013.

17. Quoted by Peter Orsi, "No le es fácil a Cuba eliminar las dos divisas," Associated Press, retrieved from *El Nuevo Herald*, 1/10/13.

18. Rosa Tania Valdés, *op. cit.*

19. "Cuba's currency: double trouble," *The Economist*, *op. cit.*

20. Emilio Morales, "Cuba: Doors to Monetary Unification," *op. cit.*

21. Vidal Alejandro and Pérez Villanueva, *op. cit.*

the chaotic ups and downs of the Vietnamese currency, the dong).

None of the authors and sources mentioned in this paper have made any reference to the many IMF-sponsored monumental disasters in dealing with monetary recipes and new currencies experiments. What lessons to draw from the Plan Austral (Argentina, 1985) which reached hyperinflation rate of 5000% in 1989; the Plan Cruzado (Brazil, 1986) reaching hyperinflation rates ranging from 230% to 500%; the Mexican peso's first collapse in the early 1980s when average inflation reached 179.73%; or Israel's overnight switch from the pound to the shekel, which reached an all time high inflation rate of 486% in 1984. And there is the infamous "Caracazo" of February 1989, resulting from a "package recommended by the IMF" (Wikipedia) where hundreds, and even thousands, were killed or wounded by the State Security and the military.

Are we to ignore such experiences? Is someone picturing or wishing for a similar outcome in Cuba? Are we to assume that the Cuban leadership is unaware of these traumatic developments? Quite the contrary, those experiences have been studied in great detail in Cuba, and everyone is well aware of their results. It would be absolutely foolish to think that the Cuban leadership is not fully aware of the complexities and risks of ending the currency duality.

## CLOSING THOUGHTS

Having reviewed and discussed many of the issues at stake, some key ideas regarding government policies should be highlighted:

- The unification process is already beginning to unfold, step-by-step, strongly inspired and guided, following a pattern of gradualism.
- The timing or stages are not to take place any time soon this year, or 18 months from now, or by 2016; all the necessary steps and adjustments are not around the corner. Convergence of the two currencies by 2018 may be a more tangible reality.
- The four pillars (no shock therapy; no egalitarianism; no destitution; no to sacrificing crucial social programs) and the three lines (do away with the old legacy; push forward and expand the reform and redesign processes; and achieve currency unification) previously mentioned, will be the guiding principles and strategies of the Cuban leadership.

A highly qualified expert on Cuban affairs, Julia Sweig, Director of Latin American Studies at the Washington, D.C. -based Council on Foreign Relations, concludes the following: "The dual currency has for years hovered over the reform process—a symbol of inequality and an obstacle to an efficient, productive economy. Raúl Castro first surfaced the need to unify the currency when he took office. I'm betting by the time he steps down in 2018, if not before, and despite the vagueness of the official language, Cuba will have a single currency."<sup>22</sup>

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22. Portia Siegelbaum, CBS News, op. cit.