PREPARING FOR A FULL RESTORATION OF ECONOMIC RELATIONS BETWEEN CUBA AND THE UNITED STATES

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The actions announced by the governments of Cuba and the United States on December 17, 2014 will have a limited immediate impact on the Cuban economy.[1] More important consequences will need to await the repeal of the Helms-Burton Act (H-B) by the U.S. Congress. I don't know when that will happen, but the recent agreement between the two countries suggests that it might be in the not-too-distant future.

For Cuban policy-makers, the key question is how best to prepare the economy to take advantage of a full opening of relations with the United States. This note is concerned with actions in the economic, not the political, area—although of course economic measures have political consequences and economic reforms require political resolve. Repeal of the H-B Act could have very significant effects on Cuban trade in goods, tourism, capital movements, and access to international financial organizations. Appropriate and early action by the Cuban government will allow the Island to take full advantage of these changes at an early stage.

RESPONDING TO THE OPENING UP OF TRADE WITH THE UNITED STATES

It is often said these days that the scope for increasing Cuban exports of goods to the United States is limited to a few products (like cigars, rum and certain medications). This may be true in the very short term. Sometimes it is also said that the government should try to identify those products which, with adequate state support, could eventually compete in the U.S. market. But that is the bureaucratic, *dirigiste* approach; it will lead to picking losers, encourage *amiguismo* and corruption, and increase subsidies—as if the effort to reduce the subsidies that accumulated after the end of Soviet assistance had not been painful enough. Over time, Cuban producers will develop a comparative advantage in other products (there is nothing wrong with Cuban imagination or entrepreneurial capacity). In this context, the proper task of the government is not to micromanage the process, but to provide a favorable environment for trade by developing infrastructure, and eliminating the constraints on both public and private enterprises, including excessive taxation and regulation. The government could also help the process by speeding up the unification and liberalization of the exchange rate system (which discriminates against exports) by eliminating price controls, and by improving the capacity of the banking system to provide payments facilities and credit to trade-oriented producers.

The scope for increasing imports of goods from the United States is large. In fact, the accumulated hunger for U.S. products may be so intense in Cuba that a surge in imports following exchange rate liberalization could trigger a serious balance of payments problem. Of course, imports can continue to be limited by quantitative controls, but this will aggravate distortions and foster corruption.

1. For an early estimate of the effects of these measures, see Luis R. Luis, *Economic Impact of the New Cuba Measures*, Ascecuba.org//blog.

- If the value of the Cuban peso is fixed at the time of the import surge, there could be an attack on the central bank's limited foreign exchange reserves. Attempts to defend the peso through intervention may lead to the depletion of reserves and ultimately a severe crisis, as discussed below.
- If the peso is floating, it will depreciate, perhaps sharply, which will help to reduce the demand for imports. This may occur with a lag, however, and in the meantime the central bank should be prepared to raise, perhaps substantially, the interest rates paid on the banking system's deposit liabilities (or whatever financial instruments it manages to create from now to then). The recent experience of Russia, and before that of Sweden, shows the efficacy of such an action to counter an excessive depreciation of the national currency. This of course implies that some liberalization of the capital account has taken place (see below). If not, balance of payments equilibrium will have to be restored entirely through adjustment of the current account, including through a fall in aggregate demand.

LIBERALIZATION OF TRAVEL BY THE UNITED STATES

A substantial increase in the number of U.S. tourists wishing to visit the Island will require, as a preparatory step, an increase in the capacity of the Cuban hotel industry. In particular, attention will have to be given to the development of the luxury end of the market, so that Cuba can compete with certain other Caribbean destinations for high-spending U.S. tourists. Efforts to attract U.S. tourists should focus not only on the development of beach resorts, but also on the organization of visits of historical sites in Havana and other Cuban cities. U.S. investment could play a useful role in these areas, provided the process is managed carefully to avoid favoritism and corruption, always a danger in dealing with large foreign enterprises. In all cases, exchange rate unification will be helpful.

EXCHANGE RATE POLICY

To help the development of the export and tourism sectors, Cuba should move as rapidly as possible towards a single, market-determined exchange rate based on a unified currency—a process that is already underway but is too gradual and excessively focused on specific sectors of the economy. The stability of the peso will depend crucially on the quality of Cuba's macroeconomic policies, particularly fiscal policy. After the post-Soviet crisis of 1989–2003, Cuba demonstrated it was able to keep the overall fiscal deficit within a tolerable range and achieve a primary surplus for the central government. But things went astray in 2008, when a loose fiscal policy coupled with an unfavorable external and climatic environment led to a surge in the overall budget deficit and a serious financial crisis, including the freeze of convertible peso accounts owned by foreign companies. The situation has now improved, but only after fiscal policy turned towards restraint, which led to a softening of aggregate demand and slow growth in recent years. This lesson must not be forgotten.

With strong macroeconomic policies, the choice between a fixed and a floating rate becomes less crucial. However, a floating rate would allow policy-makers a bit more flexibility while reducing the need for foreign exchange reserves. In the past couple of decades, fixed exchange rate systems in developing and transition countries have often collapsed in the midst of earthquake-type crises (Mexico, Argentina, Russia, Turkey and the Asian countries, among others); in most cases this was associated with excessively loose fiscal policies, aggravated in some cases by a lack of transparency. The consequences of these crises were severe, and the risk of repeating the experience is not worth taking.

CAPITAL ACCOUNT POLICY

Cuba has recently enacted a new direct investment law which has the potential to increase foreign saving, technology and management. By how much will depend mostly on how the law is administered on the Cuba side. But the potential will surely increase with the repeal of H-B. There is little doubt that U.S. direct investment, particularly in areas such as tourism and technology could be helpful.

The other side of the capital account is portfolio investment. It is clear that some liberalization of private financial flows will strongly benefit the Cuban economy by helping the development of a more sophisticated financial system and, as discussed below, by increasing saving and capital formation. To that end, Cuba will have to develop a legal and accounting framework to register and monitor claims and liabilities vis-à-vis foreigners. Initially, foreign capital is likely to flow mainly into the Cuban banks' deposit liabilities, and the central bank will have to ensure that these deposits pay reasonably competitive interest rates. Over time, however, Cuba should introduce other financial instruments, such as Treasury bills and bonds, yielding market-determined interest rates. With good policies these assets could become attractive to foreign and domestic investors while facilitating cash management by the government.

In sum, the case for capital account liberalization is strong. However, the experience of other developing countries suggests that full capital mobility capital may not be immediately desirable for a small economy, given the huge size of international financial markets and the sharp swings in confidence that frequently occur. These events could trigger at times undesirable outflow of capital, and at other times excessive inflows resulting from undue exuberance. In this situation, temporary measures such as differential reserve requirements on foreign private assets held in Cuba (similar to those introduced in the past in Chile and Colombia) could prove useful.

RAISING PRODUCTIVITY AND DOMESTIC INVESTMENT

By now, a vast empirical literature has established that GDP growth is determined fundamentally by capital formation and multifactor productivity. The administration of President Raúl Castro has already introduced a number of productivity-raising measures, most notably the large transfer of inactive employees from the state to the private sector. Probably these measures have already helped to raise total factor productivity—although so far the effects on output have been masked by a policy-induced (and inevitable) slowdown of government spending, and consequently on aggregate demand, following the crisis of 2008–09. There is still considerable scope for additional productivity-expanding measures in Cuba, including price, labor market, financial and exchange rate liberalization. But the surest and most direct way to set the stage for higher growth is to increase investment.

Capital formation is a fundamental determinant of growth. No serious economist disagrees with that statement. Since the end of Soviet assistance, investment in Cuba has been basically limited by the availability of national saving, which is constrained by low incomes, and by the resources provided by Venezuela—on which it would not be prudent to count indefinitely. Higher investment in the period ahead can be achieved without squeezing domestic consumption by increasing foreign saving, and there lies the case for higher inflows of foreign capital, as argued above. Of course, a rise in domestic investment can also be financed by reducing the government's absorption of saving through cuts in unnecessary public expenditure and subsidies—never a politically easy task. Some of these cuts have already been made since the crisis of 2008.

JOINING INTERNATIONAL ORGANIZATIONS

With the end of H-B, the U.S. government will be allowed to support a request by the Cuban government to join the International Monetary Fund (IMF). (A country must join the IMF before it can apply for membership at the World Bank.) With U.S. support, the proposal is certain to be approved by the IMF's Board of Directors. Therefore the decision to apply for membership will be in Cuba's hands.

- Membership in the Bank and the Fund could bring important benefits to the Cuban economy, particularly financial support in times of balance of payments difficulties. IMF credits would help the country to adjust without being forced to resort to excessive deflation, or default on debt payments. The IMF would become a lender of last resort, which Cuba sorely missed during the 2008–09 crisis. Of course, these benefits would be subject to IMF conditions, but these could be negotiated or even refused; the violation of national sovereignty by the IMF is a myth. IMF membership also would provide technical assistance in the monetary, fiscal and statistical areas. Last but not least, the IMF's Article IV consultation mechanism, if properly understood, could provide a valuable source of advice and discussion on macroeconomic issues and policies.

- World Bank membership would provide access to the Bank's financial resources and its expertise on project evaluation and execution, which will be essential in the development of Cuba's infrastructure in a variety of sectors including tourism, roads and agriculture. The Bank's considerable technical assistance assets would also become available.
- Similar benefits would accrue if Cuba were to rejoin the Inter-American Development Bank, and perhaps from other institutions such as the European Bank for Reconstruction and Development.

Access to the IMF will involve the submission of various documents and statistics, and Cuba should begin to work in preparation of such requests. It will have to remedy, *inter alia* the lack of balance sheets for the banking system, including the Central Bank; the lack of capital account and international reserve data; the exceedingly long delays in publishing external current account numbers; and the suppression of information on state subsidies. Cuba has much to gain by increasing the availability, transparency and regularity of its statistics, including credibility in world financial markets and provision of timely and well documented information to researchers and its own policy makers. And I don't know that it has anything to lose.

THE LABOR MARKET

As was noted above, Cuba has recently engaged in the process of reducing its bloated state payrolls and rationalizing public sector salaries to improve incentives and foster discipline and efficiency. These efforts should be pursued vigorously. In addition there is the issue of the huge implicit taxes perceived by the government on Cubans working for foreign companies (and most probably for the teachers and doctors working in Venezuela and other satellites). These practices distort the labor market, and they are unjust and discriminatory. They should be eliminated—the sooner the better—and replaced by a reasonable income tax. This would greatly improve the morale of Cuban workers and increase their productivity. The government should also seriously consider joining civilized nations and allowing the free association of workers and their right to engage in negotiations with public and private employers. I recognize that this goes counter to a long standing ideological position, but that position has no moral or practical value.

VENEZUELA

A substantial cut in Venezuelan oil deliveries (and in their counterpart, Cuban exports of professional services) will have obvious adverse implications for national income. Using different methods, Luis R. Luis, Pavel Vidal Alejandro and I have estimated the cost at approximately $7 billion—far less than the cost associated with the elimination of Soviet aid in the early 1990s (and with none of the associated technological disruptions), but nevertheless substantial. It would also have a significant effect on the Cuban labor market. Even allowing for similar agreements with other countries like Brazil, a reduction in operations under the Accord with Venezuela could mean the return of a large number of doctors and teachers that could not be easily absorbed by the local labor market. There is no easy solution, but much could be achieved by allowing these professional to operate in Cuba's non-state sector. Why not?

CODA

For half a century of Cuban history, privatization has been regarded as an evil concept. But if you examine the countries that engaged in the transition from a central plan to market, you will find a significant correlation between the private share in the economy and real per capita GDP.[2] In 2010, the private share in most of these countries was 70% of GDP or more, and 80% or more in high-income countries like the Czech and Slovak Republics, Estonia and Hungary. Cuba would have been at the bottom of that list, with a non-state sector share of 15%, in the same neighborhood as Uzbekistan, Turkmenistan and the Ukraine. Since then Cuba has made substantial progress: in 2012 the non-state sector share had risen to 25% of GDP. But it still has a long way to go.

2. Hernández-Catá, Ernesto "The Institutional Structure of Cuba's Gross Domestic Product". *Cuba in Transition—Volume 24.* Association for the Study of the Cuban Economy, 2014.