

ASSESSING CUBA'S REFORMS: GREAT EXPECTATIONS, BUT HOW REAL ARE THEY?

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The re-opening of embassies by the United States and Cuba, and the measures taken by the Administration of President Obama to move away from a policy of pushing the Cuban government to liberalize its political and economic system to one of opening new opportunities for collaboration between the two governments, have created high expectations—both in Cuba and abroad—about a recovery of the dismal state of the Cuban economy as a result of a surge in foreign commerce and investments.

How real are these expectations? What assessment can we make of the economic reforms adopted by Cuba to date and of the more recent decisions by the Seventh Congress of the Cuban Communist Party? And what can we expect in terms of foreign investment and economic growth in the near future? This note tries to address these questions.

CUBA'S TOURISM INDUSTRY

Tourism has been an important industry in Cuba for three decades. It is a significant source of foreign investment and foreign exchange. Tourism is nowadays the second largest source of foreign exchange for the Cuban economy.

There is clear evidence that there is pent-up demand by American citizens to visit Cuba, and there has been already a significant increase in visitors to the island from the U.S. in the last year and a half.

This may be attributed, in part, to the “forbidden fruit effect.” Americans have for many years not been legally allowed to visit Cuba as tourists despite the proximity of the island to the U.S. Cuba is a tropical

island with beautiful beaches which many Americans used to visit, especially honey mooners, and many Americans are eager to explore Cuba. The Cuban government is exploiting the allure of the revolution as an attraction to young Americans and the myth of visiting a country untouched by McDonald's and other American businesses.

Under these circumstances it is not surprising that the improvement of diplomatic relations between the two countries and the relaxation by the U.S. Administration of the rules concerning travel to Cuba has brought about a significant increase in Americans visiting the island under certain allowed categories of travel. This is likely to grow much more if Americans were allowed by the U.S. government to go to Cuba as “tourists.”

Despite the actions taken by the current U.S. Administration to liberalize the travel by U.S. citizens to Cuba under various categories, beach tourism has been specifically prohibited by the U.S. Congress since the year 2000 and under current legislation neither the U.S. President nor the U.S. Treasury Department's Office of Foreign Assets Control can authorize it; Congressional authorization would be required for this to change. While there have been some proposals to change the U.S. law to allow generalized travel by U.S. citizens to Cuba (i.e., tourists), there is strong opposition within the U.S. Congress to do so at this time.

A record-breaking 3.5 million foreign tourists visited Cuba in 2015. Tourism generated US\$2.5 billion in gross revenue in 2014 and US\$2.6 billion in 2013.

However, it should be noted that Cuba imported most the food and other supplies to feed, lodge and provide amenities for these tourists, since domestic production is limited and local farmers until recently were not allowed to sell directly to hotels. Thus, tourism's backward linkages to the generation of domestic product are limited, and the net revenue to the island much lower.

As the tourist industry in Cuba is controlled by GAESA, HAVANATOUR and GAVIOTA, companies owned and operated by the Cuban military, a good part of the net income generated by this activity goes directly into the pockets of the Castro family and the top military officers that control the country. Moreover, any foreign investment in hotels, golf courses, and other tourist activities has to be done in partnership with the Cuban government (with the government receiving a controlling interest in the enterprises) and the hiring of personnel has to be done from workers selected by a government company. The foreign operator does not pay the workers directly but instead pays the government company controlling the hiring, who in turn pays the workers only a fraction of the amount received for the services provided. Therefore, foreign investors in this industry have to be prepared to share the ownership and control of their operations with the Cuban military.

While there are expectations of larger inflow of tourists in future years, currently the Cuban tourist industry has some important limitations. There are questions about the government's business policies, infrastructure capabilities, and the impact of the U.S. economic embargo and travel restrictions that limit interactions between the U.S. and Cuba.

The tourist infrastructure suffers from a range of problems in marketing, maintenance, transportation, and lack of staff professionalism. While the state-controlled facilities are reported to have some 63,000 rooms among hotels, motels, apartment hotels, hostels, cabins and villas, the quality and readiness of these facilities vary widely. Recently a number of 4-star and 5-star hotels were downgraded, and there have been reports of visitors not being able to lodge in the facilities they had reserved and being rebooked in inferior quality accommodations. There also have

been complaints about the quality of the service offered by the personnel. To handle a large number of tourists from the U.S. not only new hotels would have to be built but the personnel would have to be properly trained. To be competitive with other Caribbean destinations and encourage repeated visits, tourist hotels will have to be run efficiently.

The U.S. Atlantic Coast and the Caribbean are home port to over one million motor yachts and sail boats. But, while Cuba has close to 300 natural beaches and 200 natural harbors, the Cuban government does not allow free navigation onto its ports, is not taking sufficient steps to improve marinas, and does not seem to be prepared to change its policies in this regard. Recently some cruise companies have been allowed to stop in Cuban ports, but the net value added by these cruise ship activities to the Cuban economy tends to be quite limited.

If relations between the U.S. and Cuba became truly normalized and travel restrictions eliminated, Cuba could become an ideal retirement destination for tens of thousands of Americans and Cuban-Americans who receive U.S. Social Security retirement income.

There seem to be opportunities for American and other foreign companies to profit from involvement in the Cuban tourism market. Already one U.S. company, Starwood Hotels and Resorts Worldwide, has agreed to manage the Cuban government-owned Gaviota 5th Avenue Hotel as a Four Points Hotel by Sheraton. But it is questionable whether most of the U.S. hotel industry holding companies, which are nearly all listed in the New York Stock Exchange and subject to U.S. law, will agree to collaborate with clandestine recordings and covert filming inside the hotels, as some current foreign hotel chains conduct in violation of the clients privacy, and to partner with a dictatorial government to exploit workers in these workplaces in violation of International Labor Organization (ILO) rules.

THE EXPORT OF HEALTH AND OTHER PERSONAL SERVICES

Currently Cuba's principal source of foreign exchange is the export of healthcare and other personal services, which have generated an average of about US\$6 billion per year in recent years, and an estimat-

ed US\$8.2 billion in 2014. These include services by medical doctors, nurses and other healthcare personnel, athletic coaches, teachers, and military personnel.

It is estimated that Cuba currently has some 50,000 healthcare workers deployed to some 68 countries. These services are provided through a monopoly run by the government where the workers get paid only a small fraction of what is disbursed by foreign governments and international organizations. (This practice is in contravention with international conventions of the ILO ratified by Cuba.)

In all these cases a Cuban government company collects the payments made by the government of the country receiving the services, or by international organizations, and pays the Cuban workers only a portion of the remuneration it received, which at times may be as little as ten percent of what is paid by the government receiving the services. Cubans agree to sign up to perform these international services because even the low pay received is more than what they would be paid in Cuba, where the individuals have to work for the Cuban Government since private practice of these activities is prohibited. Thus, there is a very large incentive for Cuban doctors and others to participate in foreign assignments. One undesirable consequence of the popularity of foreign assignments is that the availability and quality of medical services offered to the Cuban population in the island has deteriorated.

It should also be noted that passports of Cuban service providers working abroad are kept by officials of the State Security Department and that their families are not allowed to accompany them in their assignments abroad to prevent desertions. Moreover, the governments of the countries hosting Cuban service providers are requested that they ensure that local hospitals or other entities refrain from offering the Cuban service providers contracts to stay in the country. Despite this, a large number of participants in these international activities have decided not to return to Cuba. In these instances, the families of the "deserters" residing in the island have been punished, and the "deserters" have not been allowed to come

back to Cuba, while their families are prevented from leaving the island.

With the adoption by Cuba of a Migration Law in 2012 that eliminated the special exit permit requirement (white card) that authorized travel abroad, desertion of health care providers and Cuban athletes has grown tremendously. Hoping to cope with this problem, Cuban authorities have recently changed some of their policies concerning the treatment of doctors and athletes that have abandoned the country, permitting some of them to come back and practice once again their profession, improving their salaries and their working conditions in Cuba, and even including the possibility of receiving scholarships abroad to learn new technologies, and granting special authorization for some athletes to play in teams in other countries.

Given the high number of trained healthcare practitioners available in Cuba, the country could become an important destination for medical tourism, particularly if links could be established with U.S. health insurance groups, but for this to happen, Cuban healthcare practitioners would have to be allowed to engage in private practice.

Considering the number of researchers in the field of medicine who are currently underutilized, the country also could become a valuable partner in the medical field to major pharmaceutical companies for the development and production of new medical products. Already some French companies have been negotiating commercial agreements for the production and commercialization of some medicines and vaccines. For American laboratories to engage in these activities, however, Cuba would have to adopt international acceptable protocols to ensure the acceptance of these products in the U.S. and other international markets.

FOREIGN TRADE

Because of its strategic geographic location, Cuba is an ideal hub for distributing passenger and cargo by sea and air between North and South America and Europe. Recognizing this, and the widening of the Panama Canal that will allow the transit of mega cargo ships to and from Asia, enhancing the capacity of the Port of Mariel to allow it to receive these very

large cargo ships appeared to be a attractive opportunity. The Brazilians had an interest on this project to provide work for the Oderbrecht Company, a Brazilian construction company that was closely connected to Brazilian President Lula, and the political alliances between the government of Lula and Fidel made it possible for the Brazilian government-owned National Development Bank to lend Cuba close to US\$1 billion for this project at preferential terms. However, the large debt Cuba contracted with Brazil will raise sharply the cost of operating the port.

While the port of Mariel could provide a point of transshipment to South America's eastern coast, the most lucrative business would be transshipments to the U.S., but the latter would not be possible as long as the policy of the U.S. embargo remains in place. Some recent studies have questioned whether Mariel is the most economically desirable location for transshipment of cargo coming thru the Panama Canal destined for the U.S. given that some ships will be able to go directly to U.S. ports and that a number of other located ports in the Caribbean area also being prepared to handle transshipments and would be very competitive cost-wise to the Mariel Port. (U.S. entities are currently making large investments in a number of ports, including Miami and New Orleans, so that they can accommodate the large ships.). In fact some studies indicate that the port of Guantanamo would be a better location for transshipments, a port that is currently under U.S. control.

Despite significant efforts by the Cuban authorities to attract new foreign investments into the Mariel Special Development Zone (ZEDM) being built adjacent to the port, so far only a few foreign companies have committed to locate there and in most cases in partnership with Cuban companies controlled by the military.

Before the 1959 revolution, Cuba used to export meat, coffee, fish, vegetable and fruits to the U.S., in addition to sugar, rum, minerals and tobacco, while importing petroleum, food, raw materials, machinery and equipment. The confiscation of private farms and other businesses by the revolutionary government in the early 1960s resulted in a sharp drop in local production and a decline in exports. This was

compounded by the conversion of agricultural land to sugar cane production to try to reach the goal set by Fidel Castro of producing 10 million tons of sugar in 1970. The production goal was not met, but Cuba steadily expanded its sugar production in the 1980s on the basis of guaranteed market for sugar exports in the Soviet Union and the socialist countries. With the dissolution of the socialist bloc and of the Soviet Union in the early 1990s, the markets for Cuban sugar collapsed. Beginning in 2002, Cuba severely began to shrink its industry, so much so that sugar production currently barely covers domestic demand and contracted exports to China. In some years, Cuba has had to import sugar to meet domestic consumption and export commitments to China. In addition to demolishing about half of its sugar mills, Cuba has also allowed former sugar cane lands to remain fallow, with the land being invaded by *marabú* (a pesty invasive shrub that constitutes a serious problem for agricultural lands). Former sugar workers have left the countryside and moved to urban areas. The young people no longer have the expertise nor the desire to go back to work the soil.

The stock of cattle is today less than half what it was before the revolution, while the population of the country has doubled, so there is not sufficient meat or milk to meet domestic demand. Fields devoted to fruits and vegetables that were turned into sugar cane lands in the attempt to meet the target of the 10 million tons never recuperated their former production. Coffee production, another former export product, also suffered a very sharp drop to less than half the levels produced prior to the revolution, to the point that Cuba has had to import coffee. The controls over private fishing have also affected the possibility of developing the export of shrimp, lobsters and other marine products, while the poor maintenance of the fishing fleet has decimated its capacity resulting in a collapse of the gross catch in the last fifteen years. Moreover there has been extensive contamination of the ports and coastal areas surrounding the island and the sustainability of the coastal habitats has been compromised by overfishing and over exploitation of mangrove forests for wood and charcoal. Cuba now has to import the majority of the food it

needs to feed the population, and in some years about half of those imports came from the U.S.

Cuba has also some minerals that used to be exploited by American-owned companies. Nickel mines were taken over by the government at the beginning of the revolution and have since been exploited by a Canadian company in partnership with the Cuban government. The drop in the price of nickel in international markets in recent years has affected the foreign exchange earnings from this source.

This leaves mostly rum and tobacco as possible export products for which there would be a significant demand in the U.S.

ENERGY

One of Cuba's most significant strategic weaknesses is its acute shortage of primary energy resources, both fossil and hydro. In recent years Cuban authorities have aggressively sought foreign capital and know-how for the exploration and development of offshore oil deposits, but so far these efforts have not yielded commercially viable results. Cuba has benefitted from a barter type trade with Venezuela whereby Venezuela has provided Cuba with petroleum products in exchange for the services of Cuban medical personnel under an indenture labor arrangement that the Cuban government has set up. In recent years, the amount of petroleum provided by Venezuela has been in excess of Cuba's needs, so that Cuba was able to sell the excess in the international markets and obtain needed foreign exchange in this manner. With the drop of the price of petroleum in international markets this source of foreign exchange has declined sharply. Moreover Venezuela has faced challenges in keeping up with the volumes of petroleum products made available to Cuba and has reduced other subsidies given to Cuba. Recently the Cuban authorities announced that the availability of energy products to the domestic economy would have to be reduced, by as much as 50% in some cases.

EXTERNAL FINANCING AND DEBT SERVICE

In order to achieve sustainable growth, Cuba must import a long list of goods, including, food products, fuel, machinery, and agrochemicals. Many of these goods cannot be domestically substituted and they

are critical for the agriculture, industry, and tourism industries. These imports have to be paid with the earnings of exports of goods and services or have to be financed with credits; credits which eventually have to be paid with the proceeds of other exports. But for the most part, Cuban potential exports of goods are not internationally competitive in terms of quality, except for cigars and rum, and private individuals in Cuba are not allowed to import or export on their own without having to go thru a government agency.

In the case of the biotechnological/pharmaceutical products Cuba has managed to realize some exports to other less developed countries, but these products may find it hard to compete with the multinational pharmaceutical companies in developed countries markets where the quality of the products would need to be certified by local health authorities.

The consequence of the above situation is that any economic recovery policy for Cuba will need to attract investment that will increase the island's export capacity to be able to pay for the imports of goods and services needed to achieve a sustainable development.

Cuba had for a number of years accumulated external debt with most of its trading partners (other than the U.S., as Cuba could not trade with the U.S. because of the U.S. embargo), debt which it had been unable to service. Several renegotiations had been attempted over the years through the Paris Club but Cuba was not able to keep to the terms of those agreements. With the prospects of a re-establishment of diplomatic relations between Cuba and the U.S., the removal of Cuba from the list of countries supporting terrorist activities, and the possibility that the U.S. embargo of Cuba might be lifted, other countries were encouraged to reschedule Cuba's external debt. Thus, new negotiations have been carried out in the last three years with the Paris Club and a number of other creditors which resulted in some debt forgiveness and a reopening of short term trade credits for Cuba. It should be noted, however, that these new agreements carry an obligation on the part of the Cuban authorities to service these debts in the future, and to do so Cuba must be able to generate a suffi-

cient flow of foreign exchange earnings to do so. In his recent speech to the National Assembly of People's Power, Raúl Castro mentioned that the shortages of foreign exchange had already resulted in some delays in meeting obligations abroad and asked for understanding by the creditors of these "transitory" problems.

REMITTANCES AND OTHER SUBSIDIES

For many years, the Cuban government has relied on foreign subsidies to be able to feed its population. First from Russia, then from Venezuela, and also from the exiled community in the form of remittances.

The Soviet Union was willing to give the Castro government billions in aid to advance its influence in the Americas and to finance Cuban soldiers to fight the wars it promoted in Africa. With the collapse of the Soviet Empire, Fidel Castro turned to Chávez in Venezuela to fill the gap left by the suspension of the Soviet subsidies. With the decline in the financial health of Venezuela, the Cuban government has turned to the exiled community to provide funding for their families in the island.

In the last few years it is estimated that the remittances from the exiled community have averaged about US\$3 billion per year, which has gone to feed and clothe their relatives in Cuba, and to help finance the limited private activities that the Cuban government is now allowing. However, these private activities make only a minor contribution to the gross national product of the country.

The greatest economic challenge for Cuba is to become an efficient internationally-competitive producer without the need to depend on foreign subsidies, as it is the case today. But this is unlikely to occur in an economy where the government insists on controlling all economic activities, pays miserly salaries to its employees and stifles private enterprise.

INFRASTRUCTURE INVESTMENT

Cuba is in need of very large investments in infrastructure. Fifty seven years of neglect, poor maintenance and repairs, and very low capital investments have left the infrastructure of the country in very poor condition.

The large subsidies provided first by the former Soviet Union and then by the Venezuelan government were mostly squandered and not used for updating the country's infrastructure. As a consequence, the housing, transportation system, water distribution system, sewerage, and road and rail transportation systems have deteriorated and are currently in very bad condition. Their repair and upgrading will require very substantial investments.

Recently Cuba made public a list of 246 investments projects for which it was seeking international financing to try to lift Cuba out of the doldrums of economic stagnation in which it is currently submerged. However it is interesting to note that the Cuban portfolio of actual investments in connection with the development of the Port of Mariel consists only of 13 investments, all involving partnerships with companies owned by the government and which are unlikely to bring about a significant contribution to increase Cuba's capacity, or resolve significant infrastructure problems. Despite a large number of expressions of interest by potential foreign investors, few actual deals seem to be moving forward. Moreover, these joint companies would be required to hire workers from a specific list provided by a Cuban government company, and their salaries would not be determined by the market but instead would be established by the Cuban government and paid thru the intermediation of the Government Company that hired them.

One of the main sources for the financing of large infrastructure investments in the world are the International Financial Institutions like the World Bank and the Inter-American Development Bank, but Cuba is not a member of these institutions. To become a member, Cuba would have to rejoin the International Monetary Fund (IMF) and the Organization of American States (OAS), steps that the current government has not been willing to take. In the end, this is a political process that requires willingness by the Cuban government to accept the rules of the game and engage in political negotiations to seek the necessary support from the countries that are members of these institutions.

While the Cuban government is now seeking foreign investments, it is not allowing its own citizens to engage in independent investments or international trade. The Cuban population has shown its ability to generate successful entrepreneurs when allowed to operate in the framework of a market economy. The best proof of that is the economic success of the Cuban diaspora in Miami, which has flourished in a free market with a fair legal framework.

THE EMBARGO

One often hears people say that the U.S. embargo has not worked, but this is not the case. It is merely a misconception of the purpose and implications of the application of the U.S. embargo policies.

The embargo was first adopted as retaliation against the illegal confiscation without compensation of properties of U.S. citizens by Fidel Castro's regime. One of the main purposes of the policy was to protect U.S. companies from losses due to the actions of the Castro administration. Another was to cut the access of the Cuban government to funds to finance its subversive activities in other countries. Thus, at the beginning the embargo involved the cancellation of all trade with Cuba and of the access of the Cuban government to credits from the U.S. In these aspects, the policy has been most successful as U.S. taxpayers have not had to pay for defaulted credits given to the Cuban government over all these years. Over the past 55 years Cuba has defaulted on credits received from most of its trading partners. As mentioned earlier, it renegotiated some of these debts several times through the Paris Club and then not observed the terms of the agreements—in the end it has been the taxpayers of the creditor countries that had to absorb the losses. In the case of the U.S., because under the embargo only certain U.S. exports have been authorized and on the basis of "cash on the barrelhead" conditions, no U.S. exporter has lost any money and no U.S. taxpayer has had to cover for unpaid credits to Cuba.

The rules applied under the embargo policies have also denied the Cuban military from receiving income from American tourists going on vacation to the island, or from the exports to the U.S. of the limited goods that the island has available for export.

Raúl Castro in an address to the United Nations in September 2015, stated that the "U.S. embargo is the main obstacle to the economic development of Cuba." Clearly the lifting of the embargo would give Cuba the opportunity to generate substantial foreign exchange resources, a good part of which would go directly to the Cuban government and the military. However, even with the lifting of the U.S. embargo, Cuba would be facing significant problems to increase the rate of growth of its economy. Cuba's lack of growth is the result of 57 years of policies that have impeded economic private initiative and have failed to invest on the country's infrastructure bringing about the deterioration of the Cuban economy.

By confiscating private businesses and distributing the spoils among the supporters of the revolutionary government the authorities obtained political support, but once these business were put under the administration of state companies, the productivity fell sharply.

One important consequence of these policies was the decline in worker productivity that resulted from the lack of private activity in the island and the low wages paid by the government.

The experiences of other countries under communist regimes has shown that when the governments take control over all economic activities, stifling private initiatives, the economies flounder. The Cuban government would have to undertake a complete turnaround on its management of the economy, allowing private initiative to take the lead, for a return to sound and sustainable economic growth to be achieved.

Another extremely important factor contributing to the inefficiency of the Cuban economy is the multiple currency system prevailing in the island that results in hidden subsidies and taxes that make it extremely difficult to establish the true profitability of firms, and even the true size of Cuba's National Income Accounts.

While the Cuban Government has announced its intention to dismantle the dual currency system and the multiple currency exchange arrangement that prevail in the island, it has found it difficult to proceed with such a change. In fact in my opinion the

steps taken so far to create intermediate exchange arrangements to minimize the impact of the change on the financing of some activities tend to compound the problems by making it even harder to find out the true financial strength of the state enterprises. The government has been saying that the dismantling of the current exchange system and the elimination of the dual currencies would be done without creating losses to the population, but these changes cannot be effected without someone paying a price. The firms and individuals who are currently receiving hidden subsidies will lose them while those that are paying a hidden tax through the operation of the current system will benefit from its abolition: the problem is that with such a convoluted system, it is not easy a priori to know who is benefitting from the subsidies.

Another important reason why it will be difficult for Cuba to attract sound foreign investments is the lack of an independent and fair legal system. Already a number of foreigners who decided to risk making investments in the island have learned the hard way about the lack of fair legal process, ending up spending time in Cuban jails without due process, being subjected to requests for substantial payments to be released from jail, or even losing their lives under strange circumstances. The problem is further compounded by the lack of clarity about the existing rules, and in some cases the lack of rules altogether. This is partly due to the fact that the rulers of Cuba do not really understand how private investors think and how their investments operate. They have a very naïve vision of how enterprises operate in a market economy and tend to be prisoners of their socialist ideology. This is also why they are incapable of running the state-owned enterprises in an efficient and productive way.

We have the experience of seeing how the Cuban government acted when it ran into difficulties in meeting its foreign obligations not too long ago. When this happened, it proceeded to freeze the bank deposits of the foreign firms operating in Cuba and to prevent these firms from remitting their profits abroad. Withdrawals from those accounts and the forwarding of remittances were held hostage to for-

eign firms providing new supplies and granting new credits. Potential foreign investors should beware of what might happen in the future.

Moreover, the fact that U.S. the owners of firms and properties expropriated by the government were never compensated exposes foreign investors to legal actions brought by former owners in international courts.

THE REALITY OF EXPECTATIONS

How real are the expectations for Cuba to achieve a significant rate of economic growth in the near future?

Clearly, Cuba has beautiful beaches attractive to tourists, a lot of agricultural land and an educated population. But a commercially successful tourist industry depends on the quality of the services offered, and this can be affected by the attitudes of the local population and the condition of the general infrastructure of the country. Agricultural land has been allowed to deteriorate, the fields have been invaded by *marabú*, the peasants have abandoned the land, and the new generations are not willing to become farmers in a situation where the government continues to control the prices and the commercialization of the production. With respect to the educated population, we see a youth that aspires to leave the country because they do not see a feasible future for them and their families. Moreover, the quality of the education has been declining and there are not enough teachers to train the future generations, as many have left the country or shifted to other more profitable activities. Meanwhile, Cuba is a country with an aging population that will require social and medical services in the years to come but unable to contribute much to the economy

The position of those that control the government, as reflected in the conclusions of the recent Congress of the Cuban Communist Party, is continuing the application of the same economic policies that have failed in the past and of delaying the access of the younger generation to positions of power. Under those conditions we cannot be very optimistic about the future.

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