Currency Unification and Exchange Rate Policy in Cuba

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Today’s talk

• Full dollarization risks
• Fixing exchange rates also a mistake.
• Let the exchange rate to float.
• Dollarization will be a problem in any case.
Full dollarization a mistake

- Dollarizing not in line with the country’s competitiveness.

Cuba: Inflation acceleration in recent years, deficit financing, Vza fueled growth 2007-2017
Full dollarization a mistake

- ER regime depends on the type of external shock.
  - In Cuba today shocks come from the current account.
  - In a more integrated Cuba, we don't know.

- An inflexible ER in a first stage of liberalization would bring challenges
  - Relative prices need to reach equilibrium without output and employment costs.
  - External shocks in a liberalized Cuba come from terms of trade, financial flows.
  - Domestic shocks from inconsistency in fiscal and monetary policies.

- Inflexible ER can leave the economy at a wrong set of relative prices
  - Creates unemployment and ends in costly devaluations.

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>GDP deflator index</td>
<td>1.3</td>
<td>3.2</td>
<td>4.8</td>
</tr>
<tr>
<td>Official Exchange rate (average)</td>
<td>1.0</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>PPP exchange rate (Pesos per 1 international USD)</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Real exchange rate valuation (+) overvaluation</td>
<td>99.8</td>
<td>119.5</td>
<td>117.6</td>
</tr>
<tr>
<td>Parallel exchange rate</td>
<td>22.3</td>
<td>28.6</td>
<td>26.5</td>
</tr>
</tbody>
</table>
Full dollarization a mistake

- Once relative prices are set in hard currency, changing them would require deflation and structural reforms and they would be slow and painful.
  - The experience of hard pegs in LAC in the 1900s is telling in this regard
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  - The experience of hard pegs in LAC in the 1900s is telling in this regard.
Fixing exchange rates brings risks, fiscal numbers looking bad

- Our research done suggests that productivity has not increased in the last few decades.
- Demographic trends are extremely negative (the worst in Latam and one of the worst in the world)
- The budget was left afloat thanks to Venezuela but it has deteriorated recent years

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>2007</th>
<th>2016</th>
<th>2017</th>
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</thead>
<tbody>
<tr>
<td>Total revenue</td>
<td>36.4</td>
<td>41.2</td>
<td>28.0</td>
<td>24.9</td>
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<tr>
<td><strong>Central government expenditure</strong></td>
<td>30.9</td>
<td>37.1</td>
<td>28.6</td>
<td>26.7</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>26.6</td>
<td>33.2</td>
<td>28.6</td>
<td>26.7</td>
</tr>
<tr>
<td>Interest</td>
<td>1.1</td>
<td>1.6</td>
<td>0.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Social expenditure</td>
<td>14.3</td>
<td>19.5</td>
<td>13.8</td>
<td>10.9</td>
</tr>
<tr>
<td>Defense</td>
<td>1.4</td>
<td>1.7</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>9.9</td>
<td>10.4</td>
<td>14.3</td>
<td>15.3</td>
</tr>
<tr>
<td><strong>Capital expenditure</strong></td>
<td>4.3</td>
<td>3.9</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Public Enterprises Transfer</strong></td>
<td>7.6</td>
<td>7.1</td>
<td>12.0</td>
<td>14.0</td>
</tr>
<tr>
<td>Total Expenditure</td>
<td>38.5</td>
<td>44.1</td>
<td>40.6</td>
<td>40.6</td>
</tr>
<tr>
<td>Public Sector deficit</td>
<td>-2.2</td>
<td>-2.9</td>
<td>-12.6</td>
<td>-15.8</td>
</tr>
</tbody>
</table>
Fixing exchange rates brings risks, fiscal numbers looking bad.

- At most, if expectations are to be anchored, a crawling peg could be announced,
- Should be backed with credible fiscal policy.

Cuba: Increasing transfers to enterprises and CG deficits contributing to sharp decline 2007-2017

- Public Enterprises Transfer
- Central government balance
- Public Sector deficit
Let it Float

- The best option would be to let the exchange rate to float.
- At the beginning the float not necessarily need to be fully free,
  - The float at least would provide a buffer in the presence of unknown shocks.
- A credible and sustainable fiscal policy would be needed to avoid dollarization.

Cuba: Measures of international reserves to 2013 can be useful

2007-2017

Reserves, assume 6 months of imports
Reserves, estimates from Bankscope data
Dollarization will be a problem in any case.

- Float allows the Central Bank to keep a measure of control over monetary policy.
- Fiscal policy will have to be anchored and contracts/taxes/prices will need to be in Cuban pesos.

Cuba: M2/Reserves can serve to anchor expectations 2007-2017

- M2/Reserves, assume 6 months of imports
- M2/Reserves, estimates from Bankscope data
Conclusions

• Dollarizing has some advantages, but would likely result in relative prices that are outside of equilibrium
  – Once prices are set, changing them requires deflation and structural reforms
  – They would be slow and painful.

• Fixing exchange rates without fiscal sustainability is a mistake.
  – At most, if expectations are to be anchored, a crawling peg could be announced,
  – Should be backed with credible fiscal policy.

• The best option would be to let the exchange rate to float.
  – At the beginning the float not necessarily need to be fully free,
  – It would provide a buffer in the presence of unknown shocks.
  – A credible and sustainable fiscal policy would be needed to avoid dollarization.