

HOW WILL U.S.-CUBAN NORMALIZATION AFFECT ECONOMIC POLICY IN CUBA?

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The U.S.-Cuban rapprochement announced on December 17, 2014 will have profound effects on the Cuban economy and, therefore, also on economic policy. To begin to understand how policy is likely to change, and the probable timing and sequence of any adjustments, we need to look at both the direct effects of measures announced so far, and the repercussions and likely developments over the longer term.

Direct Effects

In economic terms, normalization measures announced to date will increase the number of U.S. citizens “licensed” to travel to Cuba; allow them to buy a limited amount of goods to bring home (with credit cards making the purchases more convenient); permit some two-way trade between the U.S. and Cuban private sectors; and enable Cuba to improve its international telecommunications links. Some rough calculations can indicate how strong the direct effect on the economy is likely to be in the short run, providing some pointers to the likely short-term impact on economic policy.

The easiest effect to estimate is that of Cuban earnings from international travel. Before the changes, the number of U.S. visitors travelling on licenses—excluding around 400,000 Cuban Americans and those travelling illegally through third countries—was around 100,000 a

year, and travel operators suggest that this number could rise quickly by as much as five-fold. Assuming that this rise happens in the first year (and that the number of U.S. visitors travelling illegally stays constant), Cuba would receive an extra 400,000 visitors in 2015. The total number of visitors in 2014 was 3 million, so this would lift total international arrivals by around 17 percent. If we assume that the average spending per U.S. visitor (including their purchases of rum and cigars) is the same as the overall average spending per visitor,ⁱ this would bring in additional gross earnings of close to US\$400 million. To put that in context, total Cuban earnings from exports of goods and services in 2014 were around US\$18 billion. Therefore, the additional U.S. visitors would boost Cuban foreign exchange earnings by something in the order of 3 percent, or about 0.6 percent of estimated GDP.ⁱⁱ

The legalization of trade with the private sector is likely to have an even more modest direct impact on the Cuban economy, for three reasons. The first is that this type of activity has already been flourishing, albeit mostly in the informal economy.ⁱⁱⁱ Second, residual U.S. restrictions and requirements continue to create legal, logistical, and payment obstacles for private-sector business, so that only a few niche activities might be expected to turn a profit. And third, the existing, small private sector in Cuba is focused on the internal export market—that is, tourism and associated activities—rather than on goods or services that could contribute to cross-border trade. The most important exception in terms of value might be the sale of Cuban art in the U.S. market, but these sales were already permitted before December 17.

Despite the limitations, the opening of this trade will greatly benefit some private businesses. Perhaps most importantly, it will improve access to equipment and spare parts that will enable them to raise productivity and expand activities.

A plausible estimate of the combined direct effects of these changes on Cuban national income in the short term would therefore be a boost of around one percentage point of GDP. On its own, this might not seem to be enough to transform Cuban lives or economic policy, but it is, nonetheless, enough to be felt.

The Cuban government's policy response will be conditioned by the limited direct benefits of the U.S. measures, which will mainly accrue to private enterprises and to Cubans involved in activities serving international visitors, thus compounding income inequality. Cuba's income gap is mainly between those who are managing to flourish in the non-state (formal or informal) economy and those dependent on still-depressed public sector earnings or benefits. A policy reform to remove limits for state salaries has improved the situations of some workers, but real average basic incomes for most state employees and welfare recipients are barely enough for subsistence.

At the same time that the U.S. changes will put the government under increasing pressure to lift basic pay and benefits, they will also increase its ability to do so, though only marginally. U.S. measures will benefit fiscal revenue by increasing tax receipts both from private enterprises and additional sales in state shops, as well as profit dividends from state enterprises catering to the new flow of visitors. If 25 percent of the estimated US\$500 million additional foreign exchange finds its way to government coffers and is shared equally between the 3.6 million state employees, annual pay per worker would increase by around US\$35.^{iv}

Interaction with Policy Turning Points: Fiscal Expansion and Currency Reform

Whether the extra lift to tax revenue will be used to raise salaries will be determined by the government's priorities. Interestingly, it comes at the same time as a shift in the

government's fiscal stance, from the retrenchment of the past five years to an expansionary phase.^v Given that the government has already budgeted for a 29 percent increase in public investment, it seems likely that the widening inequality and additional fiscal space created by the U.S. changes might at last persuade the government to ease the severe pay restraint—which seems to have been tolerated, at least in part, because it has been suffered most acutely by public servants and the older generation, the social sectors that have tended to be the least critical of government policy to date.

A more radical change in relative incomes will come when the long-awaited reform of the exchange rate system is finally introduced. The dual currency system, in place since the early 1990s, has entrenched extreme distortions, causing severe damage to economic efficiency and incentives, as well as widening the gap between the haves and have-nots. On the one hand, it overvalues the Cuban peso (CUP) at the official rate used for state entities, but bases the value of the convertible peso (CUC) on the U.S. dollar, hampering competitiveness and requiring rationing of foreign exchange. On the other hand, it undervalues the Cuban peso at the “Cadeca rate” of CUP24:CUC1 available within the informal and private sectors, so that private and informal sector earnings of just CUC 6 per week are sufficient to match the purchasing power of the average CUP wage in the state sector (CUP 514 in 2014), generating deeply pernicious effects on income distribution, incentives, and productivity.

The economic damage caused by exchange rate distortions has become more entrenched with time, but the urgent need for reform has been set against the authorities' fear of the economic upheaval that adjustment will cause. Exchange rate unification has been an official policy objective for two decades now. It was explicitly included as one of the five-year “guidelines” for policy approved in April 2011,^{vi} and plans for the day of the change (referred to

as “*día cero*”) were published in March 2014.^{vii} A nationwide process of preparation, training, and adjustment (with the official rate used by state enterprises being adjusted on a case-by-case basis) has been under way since then. The intention was to make the change by the end of 2014, but it seems that the closer the authorities have studied the disruptive impact unification will have on the price system and foreign exchange reserves, the further they have postponed *día cero*.

All of the government’s efforts to plan the one-off overhaul of the price system on *día cero* will not be able to prevent some amount of monetary instability as relative prices and wages (both market and state-controlled) adjust. This adjustment has begun, but full unification will create a major coordination challenge and price instability risks. In this context, the easing of the foreign exchange constraint that results from the U.S. changes can be expected to facilitate the currency reform and encourage the authorities to bring the date forward, because it serves to mitigate the risk of an inflationary spiral and collapse of the value of the Cuban peso, which is their fear. Barring economic shocks, a currency reform is likely within a year.

Repercussions and Reverberations

The eventual, indirect economic repercussions of exchange rate unification will be profound. It will at last allow the integration of Cuba’s two economies: the domestic one, which has operated in Cuban pesos (CUP); and the external one that operates in foreign currency or convertible pesos (CUC). By doing so, it will increase the Cuban economy’s integration into the global economy, and its economic efficiency and dynamism. It will also create the conditions for the government to reduce its role in rationing foreign exchange and fixing prices across all sectors. In this sense, it will be a greater step towards the transformation of economic decision-

making from the state planning system to the market than the much-vaunted opening of the formal non-state sector, which still only accounts for 25 percent of national employment.

Apart from facilitating the transformative exchange rate reform, the changes in U.S. rules can be expected to generate further reverberations that will transform the Cuban economy and economic policy. These effects are harder to predict and quantify than direct effects, but some of the processes that have already begun to emerge in response to the promise of normalization provide clues about likely trajectories. These include the development of networks, effect on expectations, innovation, and the altered U.S. debate on U.S.-Cuban relations.

The development of networks between U.S.-Cuban families, businesses, research institutes, cultural organizations, and policy institutes has already accelerated as a result of the relaxation of travel restrictions, and each of these groups will foster improved mutual understanding and could stimulate additional financial and economic ties, ensuring an increasing rate of growth in bilateral economic—as well as official institutional—relations. Likely improvements in telecommunications would greatly assist this process.

Expectations have also shifted. Until now, private investors from third countries have been deterred by both the lack of movement on U.S. sanctions and threat of penalties for violating them—particularly international banks and multinationals with important U.S. interests. The change in the U.S. posture has already begun to weaken the deterrent, as evidenced by an increase in business interest. Although congressional approval is needed to remove the most important U.S. measures that affect third country businesses (including the Trading with the Enemy Act and the Cuban Liberty and Democratic Solidarity [Libertad] Act, a.k.a. Helms–Burton Act), the removal of Cuba from the U.S. list of “State Sponsors of Terrorism,” which seems likely in the coming months, will serve as encouragement to potential economic partners.

For Cuban policymakers, the growth of networks and renewed third-country business interest represent policy challenges as well as bringing additional foreign exchange opportunities. Already, U.S.-Cuban networks have been crafting new initiatives at an impressive pace. New ideas for tours, flights, telecoms contracts, TV shows, and cooperation in cultural, sporting, research, and conservation activities are being reported daily. These will invigorate innovation within Cuba in all areas, including within the already-enlivened economic policy debates.

For third-country businesses, the fact that U.S. legislation continues to block their U.S. rivals provides an added incentive to move quickly to gain a foothold on the island ahead of U.S. rivals. Fearing a return to overdependence on the U.S., the Cuban government is also keen to strengthen ties with other countries and has already stepped up its effort to attract potential investors. Aware of these developments, U.S. businesses have greater impetus to intensify lobbying for legislation to remove obstacles to their participation in Cuban markets. Cuba's pointed insistence that there will be no discrimination against U.S. investors seems designed to encourage this.

The initiation of normalization of U.S.-Cuban relations has, therefore, ignited processes that are likely to accelerate. Cuba's reform process will continue to widen the opening to international markets. It will need to adapt and become more flexible in response to the direct impact of recent changes and subsequent indirect effects on networks and expectations. Meanwhile, the contradictions between a policy of moving towards diplomatic normalization and the U.S. laws that continue to block free travel, bilateral trade, and U.S. investment will become increasingly untenable. Cuban policymakers are already preparing for the new challenges that will come with the full normalization of U.S.-Cuban economic relations.

Transition?

Much of the discussion of the impact of normalization on Cuban policy has centered on the question of whether it will precipitate “transition.” But the diverse experiences of eastern European and Asian economies, as well as the huge differences between “capitalist” economies in terms of economic systems and performance, cast doubt on the meaning of the term “transition,” and its application to the case of Cuba is arguably uninformative. The idea of a “market” economy versus a “state” one was always a caricature used to distinguish the economic systems of the “capitalist” countries from the “communist” ones. In fact, the state obviously plays a crucial role in all capitalist economies (unless failed states are included in the definition), and markets have always existed within communist economies, including Cuba.

To understand Cuban economic policy, it is more useful to examine the specific drivers of change and responses than to try to measure “progress on transition.” Since the demise of the Soviet bloc, Cuba’s economic system has changed fundamentally. It has been changing constantly since then,^{viii} and normalization will herald a new phase of its ongoing process of transformation. The changes introduced already have started a process that will hasten the removal of the two greatest current barriers to efficient functioning of Cuban markets: the dual exchange rate system and U.S. sanctions. This will make the Cuban economy more open and probably more prosperous, but it will remain a mixed economy with its own unique features—including, for the foreseeable future, a comparatively large and interventionist, often inefficient but unusually effective, state.

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ⁱ The Oficina Nacional de Estadísticas e Información show 2013 gross earnings of US\$2.67 million from 2.85 million international tourists, or an average of US\$921 per person.

ⁱⁱ Using the World Bank *World Development Indicators* estimate of the U.S.-dollar value of Cuba's GDP for 2011, the latest available (<http://databank.worldbank.org/data/>), adjusted for inflation and growth to 2014.

ⁱⁱⁱ Informal trade and financial flows between Cuban Americans and their families on the island have been flourishing, particularly since restrictions on travel and remittances were lifted in 2009. Along with informal flows from Europe and elsewhere, they have been playing an important part in providing start-up capital and equipment to establish new enterprises on the island.

^{iv} It is not possible to calculate the percentage increase in real terms, due to the dual-currency accounting problem. State-sector wages averaged 514 Cuban pesos (CUP) per month in 2014, or CUP 6,170 a year, which at the “official” exchange rate (currently being phased out) converts to US\$6,170. US\$35 would represent a 0.6 percent increase. At the “unofficial,” but legal, Cadecca rate used for non-state transactions, the same amount would be just US\$256, and the extra US\$35 would represent an increase of 14 percent. The real value of the Cuban salary is somewhere in between, as many basic goods and services are sold in CUP at highly subsidized prices. After currency unification and a comprehensive price reform that is likely to ensue, it will start to become easier to evaluate real relative incomes.

^v Macroeconomic management has been very cautious in recent years, with an average increase in real government consumption of only 0.4 percent between 2010 and 2014, an average fiscal deficit of less than 3 percent of GDP, and a tight monetary policy to restrain inflationary pressures. At the December 2014 National Assembly, a more expansionary budget was approved, which increased public spending by 10 percent and widened the fiscal deficit from an estimated 4.1 percent of GDP in 2014 to 6.2 percent in 2015 (as reported in *Granma*, December 20, 2014, p.3; available at <<http://www.granma.cu/impreso/2014-12-20>>). This was in line with the draft budget, which had been

approved by the Council of Ministers at the end of November, before the U.S. and Cuba announced their agreement to work towards normalization.

^{vi} From the VI Congreso del Partido Comunista de Cuba, *Lineamientos de la política económica y social del partido y la revolución*. The reference to the currency system is in Lineamiento #55, p.15. Available at <<http://www.cubadebate.cu/wp-content/uploads/2011/05/folleto-lineamientos-vi-cong.pdf>>.

^{vii} Ministerio de Finanzas y Precios. 2014. Gaceta Oficial No. 12 Extraordinaria de 6 de marzo de 2014, Resolución No. 19/2014, Resolución No. 20/2014, Resolución No. 21/2014, March 6. Available at <http://www.cubacontemporanea.com/sites/default/files/resoluciones_192021_finanzas_y_precios.pdf>.

^{viii} The attention of outside commentators looking for “transition” has been on the opening of private markets and private enterprise, but no less important has been the gradual, “case-by-case” process of transformation of the state administration system, public services, and state enterprises. The trend has been towards decentralization of decision-making, with increased autonomy, coupled with greater financial accountability and rationalization.