

Rose Caraway
rosariotc@mail.utexas.edu
University of Texas at Austin
www.utexas.edu

Post-embargo Cuba: Economic Implications and the Future of Socialism

By Rose Caraway*
BA: December, 2003 in Latin American Studies
The University of Texas at Austin
Teresa Lozano Long Institute of Latin American Studies
December 2003

Abstract: Within recent years there has been growing debate among scholars about the possibility for normalizing trade relations between Cuba and the United States. This debate has increased within the past ten years after Cuba began instigating several watershed changes within its macroeconomic policy framework, with numerous liberalization measures. This paper will attempt to analyze the socio-economic implications of lifting the United States embargo on Cuba, particularly in the area of maintaining Cuba's wide-spread social welfare programs such as free education and health care. I provide several measures in order for the island to maintain these programs, as well as the promotion of economic stability in conjunction with open market policies and exchange rate adjustments.

* My special thanks to Jorge Mario Sánchez, whose lectures during my stay in Havana for the Fall 2002 semester provided me with very helpful information as well as the foundation for my interest in the Cuban economy.

John Quincy Adams once asked: Will Cuba be able to maintain itself? Those that fled from Cuba to the United States years later, in 1959, possessed the same doubt; so too did many well-respected Cuban economists following the collapse of the Soviet Union and the subsequent elimination of economically beneficial trade agreements between the Eastern Block and Cuba. Surprisingly, though the Cuban economy suffered significant drawbacks during the 1989-1992 period, it saw dramatic improvements following the implementation of certain macroeconomic adjustments and the gradual increase of foreign direct investment. For the past 10 years, the Cuban economy has been straddling the line between economic liberalization and maintaining social welfare programs such as free education and health care for all its citizens.

In light of Cuba's historic propensity towards economic dependence on the United States and its dollar, the most impressive challenge to sustaining its social welfare programs will be the future lifting of the US economic embargo over the island. Cuban citizens would presumably not wish to give up free education and health care under any context, regardless of who leads their government. Bearing this in mind, the single most important issue that arises is how Cuba can promote economic stability and trade with the United States while simultaneously attempting to preserve the social welfare programs

that it holds dear. This is a tall task indeed, but in this essay I provide several specific measures that Cuba may take in order to attain this goal: 1) The development of an export diversification and reindustrialization profile with the aid of foreign direct investment; 2) Elimination of the dual exchange rate and the stabilization of the local currency; and 3) Implementation of a fiscal tax policy akin to that of Norway.

Historical Background: The Embargo's Early Effects and Soviet Aid

Up until the initial implementation of the United States economic embargo on Cuba around 1960 (indeed throughout Cuba's history as both a colony and pseudo-republic following the wars for independence), both nations traded heavily with one another. Cuba's economic dependence upon the United States for the purchase of its primary product of sugar made the island especially vulnerable to confrontational force. Between the years of 1954 and 1958, especially, trade was at its highest level—exports from Cuba to its northern neighbor constituting 65 percent of its total exports, with imports to the United States totaling 74 percent of its international purchases.¹ Between May and July of 1960, the United States ended assistance to Cuba, and through Proclamation 3355, canceled 700,000 tons of the original 3,119,655 sugar quota; this resulted in a 95 percent reduction of the quota and a terrible blow to the Cuban economy.² The following December, President Eisenhower issued Proclamation 3383, which effectively reduced the Cuban sugar quota to zero in 1961.³ That same year, the United States government

¹ Castro-Mariño, Soraya, and Fernández-Tabío, Luis René. *The United States and Cuba: Possibilities for Trade Relations in the Nineties?*, p. 3

² See reference number 1.

³ Castro-Mariño, Soraya and René Fernández-Tabío, Luis René. *The United States and Cuba: Possibilities for Trade Relations in the Nineties?*, p. 4.

announced its official breaking off of diplomatic relations with their neighbor 90 miles to the south.

The United State's complete cancellation of Cuba's sugar quota devastated the island's economy, resulting in its exports to the U.S. plunging to less than 1 percent of its total exports in 1962. This, in addition to previous confrontational measures from 1960-1961, facilitated the Soviet-Cuban trade agreement: The Soviet Bloc agreed to purchase 425,000 tons of sugar in 1960, and one million tons in following four years. In addition, the former Soviet Union offered Cuba \$100 million in credits at 2.5 percent interest over a five year period.⁴ There was, however, a catch—the Soviets agreed to aid Cuba in purchasing its sugar, but at prices well below market levels. The \$100 million in credits, in addition, could only be used to purchase Soviet goods. It is estimated that over the course of three decades, the Cuban government received \$100 to \$150 billion in Soviet and Eastern European aid, not including \$1.2 billion a year in military assistance.⁵ Thus, while the economic embargo on Cuba resulted in the elimination of dependence upon the United States for the purchase of its sugar, it created a new dependence upon the Soviet Union for financial, material, and military aid. In addition, this relationship also included a compromise on a more Soviet-style of socialism that Cubans had a difficult time accepting at first. The collapse of the Soviet Union and the subsequent elimination of aid, therefore, truly tested Cuba's economic and political survival. Contrary to what many expected, the Cuba did not completely collapse, despite a very difficult period from 1989-1993.

⁴ Kaplowitz, Donna Rich. *Anatomy of a Failed Embargo*, p. 37.

⁵ Leyva de Varona, Adolfo. *Propaganda and Reality: a look at the U.S. embargo against Castro's Cuba*. p. 11.

Economic Hardship and Recovery

The collapse of the Soviet bloc coincided with one of the most devastating economic crises that Cuba had witnessed to date; GDP plummeted 34%, and Cuban trade with the countries of the Council of Mutual Economic Assistance (Comecon), which at its height reached 85%, declined by two-thirds between 1989 and 1992.⁶ Cuba's previous association with Comecon and subsequent financial and material aid had somewhat delayed the inevitable: export diversification and improvement. Supporters of the embargo (and indeed, many international economists) viewed the Soviet collapse as the last straw; the final blow to Fidel Castro's regime that would surely follow suit as a result of the severe economic downturn and crisis of the Cuban economy. Surprisingly enough, this did not occur. Perhaps out of sheer necessity, Fidel Castro and other Cuban government officials began a campaign of macroeconomic adjustment and various liberalization measures, which resulted in significant economic recovery, particularly during the 1994-1996 period.

Of primary importance was lowering the fiscal deficit, which the Cuban government achieved by decreasing state expenditures and subsidies to enterprises. As a result, the fiscal deficit dropped from 30 percent of GDP in 1993 to 7 percent in 1994 and to 2.5 percent in 1996.⁷ This both reduced the monetary overhang and decreased inflation. Three subsequent measures the Cuban government took had the greatest impact upon the Cuban economy. Firstly, the government converted Soviet-style farms to agricultural cooperatives, followed shortly thereafter by the legalization of 'farmers

⁶ Kaplowitz, Donna Rich. *Anatomy of a Failed Embargo*, p. 145.

⁷ Hernandez-Catá, Ernesto. *The Fall and Recovery of the Cuban Economy in the 1990s: Mirage or Reality?*, p. 9.

markets,' where certain products could be sold at deregulated prices. Secondly, the Cuban government legalized certain forms of self-employment in 1993, though this process went through subsequent experimental periods. It nevertheless created new jobs and allowed employees from inefficient state enterprises to seek outside employment.⁸ Thirdly, and undoubtedly the most important measure, was the decriminalization of the U.S. dollar within the Cuban economy in 1993. Up to that point, it was illegal for Cuban citizens to carry or use the dollar, which contributed to an overwhelming 'informal economy' or black market. This measure of incorporating hard currency into the market also allowed the transfer of family remittances from abroad, thus keeping dollars in circulation and subsequently increasing Cubans' income. Despite the move towards the "dollarization of the Cuban economy," the 1993 measure did not constitute a free market free-for-all. The government formed the Comisión Central de Divisas⁹, specifically designed to control how and where foreign currency is distributed throughout the country. The main uses of hard currency included its distribution to enterprises which generated foreign income, maintained certain instrumental social programs (such as education and health care), and instituted certain import substitution industrialization (ISI) measures. How are these macroeconomic adjustments and liberalization measures reflected in official statistics? Tables 1 and 2 provide key indicators of economic growth and liberalization.

Total factor productivity (TFP), calculated by subtracting fixed capital formation and labor force growth from the rate of change in real GDP, is a growth accounting framework derived from the Cobb-Douglas production function. TFP not only reflects

⁸ Hernandez-Catá, Ernesto. *The Fall and Recovery of the Cuban Economy in the 1990s: Mirage or Reality?*, p. 10.

⁹ , Jorge Mario. *The Cuban Economy: Problems, Politics, Perspectives*, p. 5.

factors not included in measurements of capital and labor, but also the difference between actual and potential output.¹⁰ Table 1 indicates a sharp decline for the 1992-1993 period. Such a decline was expected considering the intense shocks the Cuban economy experienced after the end of Soviet aid. Astounding growth in 1994 of not only TFP, but of real GDP, real power consumption, labor productivity, and real GDP as a percentage of total employment is surprising to say the least and a bit difficult to explain. I believe, however, that these figures are a reflection of the partial liberalization measures implemented by the Cuban government—the conversion of the agricultural sector to cooperatives, decriminalization of the U.S. dollar, and the legalization of some self-employment. Cuba's lackluster economic performance during the 1997-1998 period could be explained by a decrease in the use of the previous liberalization measures. The 1994-1996 period, however, suggests vast improvements within the Cuban economy despite both the end of Soviet aid and a tightening of the United States embargo. Table 2 indicates continued substantial growth in overall GDP for the period 1998-2002, despite a recent decrease in percentages of real GDP growth.

These statistics by no means should imply that inefficiencies do not exist within Cuba's highly centralized economic system. There remains a significant lack of financial institutions that provide credit in order to induce much-needed domestic savings; entrepreneurial activity is prohibited in that Cubans are not permitted to establish their own companies, nor are they allowed to hire employees; lack of privatization within internal markets decreases the efficiency and productive capacity of state-run institutions;

¹⁰ Hernandez-Catá, Ernesto. *The Fall and Recovery of the Cuban Economy in the 1990s: Mirage or Reality?*, p. 11.

and tight governmental control over external financing and the exchange rate (or rates, in Cuba's case) has caused troubling economic issues that should be addressed.

The Cuban government's use of the Comisión de Divisas is understandable considering their desire to control how and where foreign currency is circulated; it is through this control that social welfare programs are funded. I would suggest, however, that Cuba possesses the ability to increase economic productivity while simultaneously providing funding for nationalized health care and education.

Table 1. Cuba: Macroeconomic Adjustments and Liberalization Measures
(percentage changes)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Macroeconomic Adjustment										
1. Real GDP	0.7	-2.9	-10.7	-11.6	-14.9	0.7	2.5	7.8	2.5	1.2
2. Real power consumption	4.1	-0.8	-13.1	-13.4	-7.3	6.9	2.4	7.2	7.0	1.2
3. Total factor productivity	-3.4	-6.2	-11.8	-9.3	-12.4	4.5	4.7	9.5	3.1	2.3
4. Labor productivity, industry	...	-6.1	-24.0	-24.1	-9.0	21.4	14.4	14.7	5.8	8.4
5. Real GDP/total employment	...	-4.1	-15.5	-10.0	-14.6	0.0	9.0	6.8	0.3	-0.1
Liberalization Measures										
6. Private employment	...	4.7	6.3	9.8	22.4	95.9	13.3	1.4	7.7	8.3
7. Non-state employment share	5.6	5.8	6.2	6.9	8.6	19.0	22.3	22.7	24.0	26.1

8. Non-state agricultural land share	22.0	73.6	74.3	74.5	75.6	...
--------------------------------------	------	-----	-----	-----	-----	------	------	------	------	-----

Sources: Economic Commission on Latin America (1997) and the International Monetary Fund Working Paper: Catá, Ernesto Hernández, *The Fall and Recovery of the Cuban Economy in the 1990s: Mirage or Reality?*

Table 2. Annual Indicators, 1998-2002

	1998	1999	2000	2001	2002
GDP at market prices	25.9	28.1	30.3	31.6	34.6
GDP (US\$ bn)	20.3	22.1	24.1	25.5	26.2
Real GDP Growth (%)	1.2	6.2	5.6	3.0	1.1

Sources: Economic Intelligence Unit. Country Report: Cuba. Feb. 2003

Export Reindustrialization and Foreign Direct Investment¹¹

The Cuban government has taken advantage of foreign direct investment (FDI) in the past in order to generate much-needed hard currency, and this appears to be a very efficient and productive way to do so in the future. However, in order to make the most use of its well-educated work force, Cuba might consider diversifying its export sector beyond the intensive utilization of natural resources.

Following the 1989-1992 economic crisis and in conjunction with the macroeconomic reforms taken, Cuba's primary monetary policy consisted of an import substitution industrialization profile designed to re-integrate the economy into the international market while simultaneously attempting to protect the domestic market from

¹¹ This concept is discussed in further detail in Pedro Monreal's article *Export Substitution Reindustrialization in Cuba: Development Strategies Revisited*

an externally-induced collapse. In 1996, the Cuban government stated that \$2.1 billion had been committed to investment in a variety of industries ranging from tourism to agriculture; in February 1998, the government announced that foreign companies had invested in 332 joint ventures.¹² While this model was relatively successful on various fronts principally due to the introduction of foreign capital as a result of foreign direct investment (FDI) and the creation of joint ventures, continued use of this profile does not appear to be the most effective means by which Cuba can advance its external financing sector. In addition, there remains the issue of discrepancy between foreign investment promised and the amount actually delivered. In the future it will become increasingly important for Cuba to take advantage of the highly skilled and educated work force that it possesses in order to produce more technologically advanced products suitable for the world market. With a future lifting of the United States economic embargo on the island, there is vast potential for the exchange of vital technology in order to aid Cuba in ‘moving up the export ladder.’

Traditionally, Cuba’s principal products for export have been primary—those based on the intensive utilization of natural resources rather than skilled labor. This continues to the present, as seen below:

Table 3: Principal Exports, 2001

Principal Export	US \$ M
Nickel	438
Sugar	551
Tobacco	261

¹² Jatar-Hausmann, Ana Julia. *The Cuban Way: Capitalism, Communism, and Confrontation*, p. 123-124.

Seafood	79
---------	----

Sources: The Economist Intelligence Unit. Country Report: Cuba, 2003.

There have, however, been recent endeavors to promote the production of semi-manufactured (tobacco, processed fruits and vegetables) and manufactured goods (cement, iron and steel, pharmaceutical products, oil and gas). While these efforts are minimal at present compared with the continued exploitation of natural resources, there is significant hope that they will be utilized in the future, particularly if trade relations are normalized with the United States; Cuba would then have even greater access to technological potential. Currently, Cuba has several promising projects in operation that utilize foreign direct investment (FDI) and the development of new technologies and infrastructure.

Principal imports, 2001	US \$m
Machinery & Equipment	1,234
Fuel	977
Food	822
Chemicals	477

Main origins of imports, 2001	% of total
Spain	12.7
China	7.6
Italy	5.7
France	5.0

Mexico	4.0
--------	-----

Sources: The Economist Intelligence Unit. Country Report: Cuba, 2003.

Petroleum and Gas

Within the petroleum and gas sector, there are 20 risk contracts (contracts in which foreign companies understand the risk of prospecting) with international companies from Canada, France, Britain, Sweden, Brazil, and several others. As of this year, joint venture investment accounts for approximately 60% of oil production.¹³ These investments have introduced more cost efficient technologies to Cuba such as horizontal and multi-pipe perforation, improvements in pumping systems, and the construction of plants for the treatment of crude oil.¹⁴ These efforts have resulted in an increase of oil production (2002) by 25.7%, or 3.63 million tons.¹⁵ This year may prove to be promising in terms of off-shore exploration; the Spanish company Repsol is expected to drill a test well in Cuba's Gulf of Mexico territory. It would certainly behoove Cuba to take advantage of off-shore drilling and exploration, particularly if the United States would later be willing to invest in such efforts after the lifting of the embargo.

Biotechnology

The area of biotechnology has the potential to be extremely profitable for Cuba both financially as well as socially, in terms of providing high quality medicines and vaccines for its citizens as well as the global market. In addition, it is one of Cuba's few export sectors that truly involves intense utilization of its skilled labor force—extremely vital in producing more diverse, technologically advanced products for export. Biotechnology

¹³ The Economic Intelligence Unit. Country Report, August 2003.

¹⁴ Villanueva, Omar Everlery Pérez. *Foreign Direct Investment in Cuba: Recent Experience and Prospects*, p. 60.

¹⁵ The Economic Intelligence Unit. *Country Report: Cuba*, 2003. p.23.

scientists from around the world, including the United States, are exchanging vital information with Cuba on the engineering of plants and animals for drug production. The island has been particularly successful with the development of vaccines, such as one for hepatitis, and it hopes to develop an effective HIV vaccine as well as anti-HIV medications. Cuba is presently in alliance with India and other Southeastern Asian countries, and has joint ventures with Japan and Canada in pursuit of biotechnology development and sales.

Electronics and Telecommunications

Foreign direct investment has been particularly effective within the electronics and telecommunications sector as well. In 1994 Cuba created its first privatized business—ETESCA, the product of a joint venture between a local Cuban telephone company and the Mexican company CITEL.¹⁶ Foreign capital has provided Cuba with much-needed improvement in its telecommunication infrastructure, with the installation of up to date digital plants, microwaves, fiber optic technology, and universal access to email accounts. The electronics industry reported significant growth (10.1%) as of 2002, and the state's main corporation, Grupo de la Electrónica, has recently signed a production agreement with a Chinese company for the manufacture of electronics using Chinese technology.¹⁷ While it is still within its infancy stage, development of software is on the rise as well.

Tourism

While tourism does not fall within the semi-manufactured or manufactured export category, it is certainly worth mentioning as it constitutes one of Cuba's greatest sources

¹⁶ Villanueva, Omar Everleny Pérez. *Foreign Direct Investment in Cuba: Recent Experience and Prospects*. p. 62.

¹⁷ The Economic Intelligence Unit. *Country Report: Cuba, 2003*. p.24.

of capital. In 1995, the Cuban government instigated a new foreign investment law designed to attract capital into tourism. This has been quickly replacing sugar as the primary generator of gross income; tourism as a percentage of GDP rose to more than eight percent in 1999, and also contributed to a substantial increase in the exports of goods and services—a rise from 5.8 percent in 1990 to 30.3 percent in 1999.¹⁸ The Cuba Policy Foundation reports that for the 1999-2000 period, gross income from tourism grew by 8.1%. The Ministry of Tourism expects this year's figure to reach \$1.9 million, a 13% increase from last year.¹⁹ In another unprecedented liberalization move, Cuba passed a foreign investment law which allowed outside investors to outright own Cuban enterprises—a large percentage of them in the tourism sector. In 1999, for example, the number of joint ventures with foreign companies for hotel construction reached 7, which essentially amounted to 19 foreign hotels chains operating in the country. Despite the U.S. travel ban to Cuba, which has been in effect for over 3 decades, Cuba received 160,000 American tourists to the island in 1999,²⁰ illustrating that the island has been able to attract American dollars despite the embargo. While this sector of the economy has been particularly profitable, and most likely will continue to be in the future, it is important to bear in mind that tourism by means of attracting capital and hard currency remains more of a short-term measure by which the Cuban government is attempting to increase revenue. In order to truly insert its economy back into the international market at a competitive level, the Cuban government must take decisive measures in order to

¹⁸ Nodarse, Hiram Marquetti and Capote, Anicia García. *Cuba's Model of Industrial Growth: Current Problems and Perspectives*, p. 77.

¹⁹ The Economic Intelligence Unit. Country Report, August 2003.

²⁰ Associated Press, Washington, D.C. Internet Article.

http://www.bangla2000.com/News/Archive/International/6-14-2000/news_detail8.html

14 June, 2000.

create an open-market conducive to the exchange of technology, ideas, capital, and the utilization of its skilled and educated population.

Although the Cuban government has taken decisive measures within the past 10 years to open certain sectors of the economy to foreign investment, significant non-tariff barriers still remain. In foreign investment agreements, for example, the Cuban government has assured its trading partners that there will be investment protection as well as security from expropriation. The 1994 foreign investment law stipulates, however, that in cases of “public good or in the interest of society”, the Cuban government may expropriate assets and compensate the foreign entity in freely convertible currency. These ‘cases’ are not specifically defined, and such a scenario could conceivably alarm foreign businesses. In a more recent situation, the Banco Central de Cuba (BCC) has undertaken a more centralized role in the allocation of hard currency, which has alarmed foreign businesses. The BCC in response has assured lenders guarantees for all letters of credit, as well a decrease from 2% to 1% in the exchange commission rate.²¹ While these protection agreements are certainly indicative of the Cuban government’s willingness to provide a favorable investment climate, they also indicate that Cuba is determined to sustain control over investment flows at the national level. In a post-embargo scenario, the Cuban government would presumably need to at least consider United States financing through banks and corporations, something that the Cuban regime is wary of. Ernesto Hernández-Catá states in the International Monetary Fund Paper of 2001:

“...the considerable, favorable effects of the partial liberalization measures implemented in 1993-1994 indicate that a complete reform program would have a far-reaching beneficial

²¹ The Economist Intelligence Unit. Country Report, August 2003.

impact on the Cuban economy. But this would mean getting the government out of the people's way, and allowing Cubans (and not only foreigners) to work, invest, and realize profits." (p.20)

This is indeed the catch-22: in order for the Cuban economy to truly flourish and remain competitive at an international level, it becomes necessary to introduce complete reform—that of the free market. Traditional theory would suggest that one cannot choose this route and simultaneously have a highly centralized system of which socialism is comprised. In other words, socialism and capitalism do not mix; one system is intrinsically communal, the other individualistic. The irony here is that this is exactly what the Cuban government has been attempting to achieve these past 10 years—an economy molded by hand, so to speak.

It is important at this juncture to distinguish between private capitalism and state capitalism—the latter has been promoted and very much embraced by the Cuban government, while the former has neither been institutionalized, nor legitimized. Despite Law-Decree 141, which did legalize limited forms of self-employment, the government is not completely comfortable with the notion of the Cuban entrepreneur. It does, however, wish to attract foreign investment and joint ventures into numerous sectors, with the understandable exception of health care and defense. This is indeed the primary difference between the form of capitalism that the U.S. promotes and the form that is rapidly emerging in Cuba; the Cuban regime views state capitalism and large foreign investments as less of a threat to its socialist ideology compared with small, private investment. If, however, trade relations with the United States are normalized (i.e., the embargo lifted) at some point in the foreseeable future, *and* private, entrepreneurial capitalism is legitimized, it is unlikely that the socialist state in Cuba will survive.

Bearing this in mind, how exactly can the Cuban government simultaneously decentralize and streamline its economy without completely destroying its social welfare programs that are in line with socialist ideology? Of primary importance is the stabilization of the local currency, followed by (and in conjunction with) the introduction of a fiscal tax policy that would continue to provide these social services.

Dollarization and Dual Exchange Rates: Problems and Perspectives

In order to pave the way toward a more stable and prosperous economy, I propose that Cuba implement a monetary policy by which to achieve a single monetary unit. This may be achieved by either adopting the dollar as the sole form of currency, or devaluing the local peso by deregulating the exchange rate. Cuba currently uses three different currencies; while some economists may find this as odd, this situation originated during a period in which the collapse of the Soviet Union forced the island to discover whatever means necessary to economically recover.

In 1993, the Cuban government was forced to abandon its previous law banning the use and possession of U.S. dollars. With massive shortages, virtually a complete lack of hard currency, and a dismal exchange rate of 150 pesos to 1 dollar²², Cuban authorities had no other option. In conjunction with this watershed initiative to introduce foreign capital into the system, Cuba instigated various import substitution industrialization (ISI) policies in order to protect domestic and infant industries and shield the Cuban economy from the externally-induced crash that had befallen it during the early 90s. One of these protective measures included a dual-exchange rate. The “official” exchange rate, used at

²² Class discussions—the Cuban economy. Presented by Jorge Mario Sánchez, October 9th-16th, 2002. Havana, Cuba.

the national level for direct, international trade, is \$1 to 1 Cuban peso. The quasi, “unofficial” exchange rate, however, is used at the domestic level and with street transactions. It varies yearly, but has fallen dramatically as a result of the macroeconomic policy adjustments taken in 1993—from 150 pesos/ dollar to 26 pesos/ dollar (as of 2002). The “official” 1 to 1 exchange rate allowed the Cuban government to import products at a drastically reduced rate, lest they would have been forced to pay for imports with a dismally deflated peso. In addition, the Cuban government initiated the use of yet another currency, the ‘convertible peso’—essentially the same value as the dollar, and again designed to capture foreign currency into the system, as well as to curb the disturbingly high black market demand for dollars.

While these measures certainly proved quite necessary and essential during the “Special Period”, the problem is that the continued implementation of the dual exchange rate has caused a conglomerate of problems far beyond the scope of even this paper. The main issues that arrive from monetary duality, however, are a lack of incentive among the Cuban population and the false inflation of the peso with a simultaneous reduction of its purchasing power. As the amount of dollars circulating within the system increases, so too does the disparity between those Cubans who have access to dollars and those that do not. Inequity among Cubans is perpetuated by the presence of foreign currency stores charging higher than normal prices, in addition to an increase in foodstuffs sold within those dollar stores; this increases demand for the dollar while simultaneously decreasing demand for the local peso. It was rare indeed to encounter a store which sold products in both dollars and pesos; it is inevitably either one or the other, and the few remaining

vendors whose transactions *are* conducted in the local currency are primarily domestic and generating very little revenue compared to the foreign currency stores.

While the initial goals behind measures toward dollarization of the economy have been achieved (namely increasing the amount of hard currency within the system), they have also decreased the incentive that every day Cubans have to remain earning state salary—the equivalent of \$10-20 per month in income.²³ As Cubans working within the tourism industry have the possibility of earning more than \$20.00 in one day, there exists an adverse turnover rate from lower paying, higher-skilled jobs to higher income, lower-skilled jobs. While certainly understandable within the short-term, this situation has detrimental consequences in terms of preserving Cuba’s long-held position of breeding a highly skilled and educated workforce.

Although the “official” one to one exchange rate has reduced import costs and been especially beneficial to certain sectors of the economy, it has falsely inflated the value of the peso while simultaneously reduced its purchasing power. Using a multiple exchange rate system creates for a volatile economic situation as unification becomes a more and more difficult goal to achieve. In addition, the most sensitive sectors of the economy, that which include primarily social services, do not benefit from the official exchange rate as they are maintained using the peso. As the demand for dollars steadily increases and the purchasing power of the peso decreases, the gradual ‘fading out’ of dollarization becomes less and less of a possibility. How then, can Cuba solve this problem of monetary duality? The two most feasible options include either a) implementing open market policies to promote a transition to a floating exchange rate,

²³ See footnote #18.

thereby gradually strengthening and maintaining a stable peso vis-à-vis the U.S. dollar, or
b) eliminating the peso altogether and adopting the dollar as the sole form of currency.

I believe that at this juncture it is unlikely that the Cuban government will adopt the latter scenario. It is also highly unlikely that the Cuban peso will ever reach the value of the dollar unless drastic measures are taken. Though in reality no less drastic of a measure, the elimination of the peso and the adoption of the dollar as the main currency would most likely produce less of an economic shock upon the system. Any emerging and developing market economy is especially vulnerable to exchange rate fluctuations, and the sole adoption of the dollar would certainly minimize this concern. In addition, by providing all local services--including those social services that include education and health care benefits--in dollars, the loss of monetary incentive is virtually eliminated. This creates additional problems, though, due to the fact that losing monetary incentive contradicts traditional Marxist thought; once one introduces the capitalist dollar into a system that previously did not depend upon it, socialist ideals are tested.

Strengthening the domestic and international role of the Cuban peso against the U.S. dollar would require a dramatic devaluation policy specifically designed to target long-term stability. While most Cuban analysts find this model to be most desirable, they also maintain that it would be entirely too costly and unreasonable considering current circumstances. According to Jorge Mario Sánchez, “it is not reasonable to expect drastic changes in the general economic reform process in the medium term, particularly in that area of economic policy.”²⁴ Sánchez, along with most Cuban economists, fear an inflationary backlash as a result of the sudden devaluation of the peso and a flexible, floating exchange rate. They acknowledge as well that economic stabilization and

²⁴ Sánchez Egózcue, Jorge Mario. “The Cuban Economy: Problems, Politics, Perspectives.” p. 19.

revival is impossible without this abrupt and drastic change. I would suggest that the expected inflation, in accordance with devaluation, does not have to constitute a be-all, end-all scenario, in which hyperinflation and a massive economic crisis results.

Inflation targeting

If the Cuban government would not be comfortable with devaluating its peso all at once, it could do so gradually--say, over the course of five years--in order to avoid hyperinflation. In conjunction with this more gradual method, it might prove feasible to instigate inflation targeting (IT) techniques akin to those that Brazil implemented beginning in 1999 following the devaluation of its *real*.²⁵ Attempting IT in a similar manner to the Brazilian case would require the creation of an entirely new framework in monetary policy; the Banco Nacional de Cuba would be given sole and independent discretion in conducting monetary policy, a watershed move indeed, but plausible considering Cuba's highly skilled and forward-thinking workforce. Providing the Cuban National Bank with this power is crucial in developing sophisticated inflation-forecasting models. A set, yet modifiable interest rate would play a key role in combating inflationary pressures, and instead of addressing issues as they arose, small and simple macroeconomic models would be used in conjunction with frequent, open reports on the monitoring of inflation targets in order to *prevent* inflation from spiraling out of control. It is hoped that various international communities would aid Cuba in providing

²⁵ Brazilina Embassy in London: Recent Developments of the Brazilian Economy. Internet Article. <http://www.brazil.org.uk/page.php?cid=115&offset=1>

educational conferences by which to learn the most efficient ways to implement inflation targeting techniques, as they did in the case of Brazil.

Capital control

Much debate has been generated recently regarding the benefits and disadvantages to instigating capital controls. Let us assume that Cuba will want to expound upon previous liberalization measures and consider implementing open market techniques if trade relations are normalized with the United States. There are several reasons why Cuba may be considered a potential future candidate for some form of capital control if American businesses are allowed to fully invest in the Cuban market:

- The presence of an inflexible exchange rate regime. Present tight governmental controls over exchange rate(s) cannot withstand the volatility of free flowing capital.
- U.S. companies have already expressed interest in investing in Cuba, even upon tightening of the embargo due to Helms-Burton legislation. From 1994-1996, The Economist reported that 1,500 representatives of American firms made trips to the island in search of possibilities for future investment, and in 1995 the Cuban Ambassador to the United Nations announced that 100 U.S. companies had signed a letter of intent to invest if trade relations were normalized.²⁶ This commitment underscores the possibility that once trade with the United States is initiated, Cuba could see massive short-term capital inflows.
- Cuba's historical mistrust of unfettered capital market liberalization. Up until 1993, the Cuban government did not allow foreign companies to own any part of their industries outright. It is important to distinguish here the difference between foreign direct

²⁶ Werlau, María C. Foreign Investment in Cuba: The Limits of Commercial Engagement. pgs. 3-4. May be downloaded at http://www.lanic.utexas.edu/la/cb/cuba/asce/cuba6/57Werlau_fm.pdf

investment and full capital account liberalization. The latter is uncontrolled; that is, capital is allowed to freely flow and gravitate toward the most productive and efficient companies and industries. This free-flowing capital includes investment of foreign assets into a nation's stock market and equity. Foreign direct investment (FDI) does attract foreign capital, but not in an uninhibited form; FDI involves investment into a nation's domestic organizations and structures, not its equity. It is therefore seen as more stable within the long term, as full capital account liberalization can lead to sudden capital flight, as seen in the cases of Brazil, Asia, Russia, and Argentina. The capital controls that Chile instigated in 1991, also known as the *encaje*, were put in place to harmonize discrepancies between domestic and international policies, combat inflation, and change "the term composition of the capital flows received by Chile toward long term and more stable flows such as foreign direct investment."²⁷

This is not to imply that Cuba should not consider full capital account liberalization and solely rely upon capital controls rather than committing itself to the establishment of a more broad, fundamental policy structure. However, even the International Monetary Fund agrees that "a case can be made that controls on inflows may be justified on prudential grounds in situations of a weak domestic institutional and regulatory environment, and as a means of coping with external market pressures."²⁸ In applying any new economic framework, it is no doubt important to look at all options from all angles in order to achieve the best suitable profile.

²⁷ Gallego, Franciso A. and Hernández, Leonardo F. Microeconomic Effects of Capital Controls: The Chilean Experience During the 1990s. p. 21. May be downloaded at

<http://www.bcentral.cl/esp/estudiospublicaciones/estudios/documentostrabajo/pdf/dtbc203.pdf>

²⁸ Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System. International Monetary Fund. 26 April 1999. Available on the internet at <http://www.imf.org/external/np/omd/1999/042699.htm#IV>.

Regardless, considering Cuba's lack of a completely sound financial and banking sector, its propensity towards inflation, and the fact that it has not maintained a completely open market for over 42 years, it might be wise to move toward gradual capital account liberalization, perhaps first concentrating on the expansion of generating inflows through foreign direct investment. Of primary importance is the elimination (whether gradual or otherwise) of the dual exchange rate and the achievement of a stable local currency, or the adoption of the dollar as the sole currency. If the Cuban government does indeed not wish to devalue the local currency out of fear of an inflationary backlash, it can explore the possibility of creating a framework to initiate inflation targeting techniques. While not to be considered an economic crutch, capital controls are an option if Cuba wishes to consider controlling short term inflows when trade relations with the United States are normalized.

Tax policy in accordance with maintaining social welfare programs

In contemplating the most efficient and feasible way in which Cuba could maintain its broad sweeping social welfare programs in conjunction with a stabilized and open market economy, I looked to the Norwegian economic and tax systems for a comparable analysis.²⁹ Although Cuba will first need to stabilize its currency and become accustomed to an economic policy that embraces the free market, I believe Cuba to be fully capable of retaining its socialized medicine and health care programs by imposing an all-encompassing tax of approximately 50% on its working citizens. Several requirements would, of course, need to be met in order for this to be plausible. First and

²⁹ Information about Norway's fiscal and economic policy received from the Norway country report, available at <http://www.state.gov/documents/organization/1627.pdf>, and the Mission of Norway to the European Union, available at <http://ud2.mogul.no/cgi-bin/wbch3.exe?d=4868&p=2238>.

foremost, Cubans must be able to tap into their entrepreneurial potential in order to generate income for themselves. Under the current situation, instigating a tax policy designed to attract revenue from half of a Cuban's income would be inefficient, since the majority of Cubans' income is distributed in the local peso. Indeed, this would be considerably easier to implement if Cuba adopted the dollar as its principal form of currency as discussed earlier. With the dollar economy, the remaining 50% of a Cuban's income not taxed would be in the form of dollars, the value of which tends to increase exponentially over time. If, however, the Cuban government intends to implement this policy using the national currency, it will be absolutely necessary to not only stabilize it over the long term, but increase its value vis-à-vis the U.S. dollar.

Norway's general policy framework includes maintaining the stability of its local currency both within the short and longer terms, the promotion of international competitiveness, and preserving its social welfare programs. The first priority is achieved by implementing open market policies in conjunction with adjusting the interest rate as needed and determined by the central bank. Its currency, the *kroner*, is kept stable and under a managed float vis-à-vis the Euro, via interest rate adjustments. Although credit flow restrictions from private institutions were abolished in the late 1980s and foreign exchange restrictions effectively eliminated in 1990, subsidies and tariffs over the agricultural sector still remain. The Norwegian state still owns about 50% of the nation's domestic businesses, and controls stakes within the central bank and oil industry. Norway is still a member of the World Trade Organization, however, and generally supports measures of free trade. In addition, tax grants and government grants are issues in order to promote investment as well as the use of environmentally-safe products in

various industries. Despite some trade restrictions, Norway and the European Union have substantial access to each other's markets, and U.S. companies operate profitably within Norway's petroleum and gas sector.

In order to facilitate and maintain the generous welfare benefits to its citizens, Norway's marginal tax on employment income or self employment is approximately 55.3%.³⁰ Tax relief is offered to those individuals under 34 years of age attempting to save for a house, and persons living within the northern regions of the country. Indirect taxes are also levied on certain goods and services as well as specific imports from abroad. In order to manage fiscal policy as well as the eventual decline in petroleum revenue, the Norwegian government established the Government Petroleum Fund in 1990. The funds derived from this area cover the non-oil budget deficit, thereby balancing the total budget surplus in oil revenues with net allocations in the fund itself. This tight fiscal policy, as well as the commitment to currency stability and the efficient use of both private and public resources, has made this juggling act between maintaining social welfare and economic prosperity possible.

Norway's economic framework is particularly interesting due to the fact that Cuba could be in virtually the same position if it implemented some of the same fiscal and monetary policies that Norway promotes. If, for example, the Cuban government does indeed decide to devalue the local peso, aim for a floating exchange rate, and subsequently attempt to explore inflation targeting techniques by allowing its central bank to carry out monetary policy, it could enjoy the same economic stability that Norway has. Although implementing a similar tax policy does not appear to be within

³⁰ The Norwegian Tax System. Internet article available at the Ministry of Finance, <http://www.dep.no/fin/engelsk/p4500279/index-b-n-a.html>.

Cuba's immediate grasp, this tax policy is plausible if the island opens itself to free trade and stabilizes its currency. Another striking similarity is the vast potential for wealth within Cuba's petroleum and gas sector, provided that it continues expounding upon foreign direct investment and exploring new reserves off of its Gulf of Mexico territory.

Conclusions

In light of the fact that U.S. businesses are already investigating investment opportunities now in Cuba, so as to secure foundations on the island if (more likely when) the U.S. lifts its economic sanctions, it is becoming likely that at some point in the foreseeable future, United States corporations will play a pivotal role in various areas of Cuba's economic sector. This places socialist programs at risk, as it forces privatization measures to be set up. With limited entrepreneurial activity, over-valuation of the currency, multiple exchange rates, and an extremely volatile infrastructure, a post-Castro Cuban government will have to adopt certain measures in order to maintain social programs such as wide-spread free education and health care for all citizens that they presumably would not wish to eliminate under any context. This remains a tall task indeed, as capitalism and socialism generally do not mix efficiently.

Despite the fact that most analysts concluded that Cuba would not survive economically, it did manage to do so by instigating very specific liberalization measures in conjunction with watershed adjustments in macroeconomic policy. There remain, however, several hurdles to overcome if Cuba wishes to truly succeed economically; principally, increasing the value of the peso via the U.S. dollar over time, thereby achieving exchange rate stability. After successfully arriving at this goal, the Cuban

government may then look to implementing a tax policy designed to sustain free education and health care. This may be achieved only after Cuba not only stabilizes its currency, but after its citizens are allowed to expound upon their entrepreneurial potential and be able to enjoy full self-employment as well as hiring and firing privileges.

A very difficult road no doubt lies ahead of this robust little nation. Considering its historical dependency upon the United States for economic prosperity, a unilateral lifting of the embargo will pose a significant challenge to the island. I truly believe, however, that Cuba has within its capacity the ability to “have their cake and eat it too”, so to speak. Realizing that this is certainly idealistic in nature, experience has also led me to believe that if anybody can achieve this idealistic scenario, Cuba can. Their unbelievable ability to survive despite several externally-induced nightmares makes this possible. ¡A pesar de todo, vencerán!

References

Associated Press, Washington, D.C. Internet Article.

http://www.bangla2000.com/News/Archive/International/6-142000/news_detail8.html, 14 June, 2000.

Brazilian Embassy in London: *Recent Developments of the Brazilian Economy*.

Available at <http://www.brazil.org.uk/page.php?cid=115&offset=1>.

Castro-Mariño, Soraya and Fernández-Tabío, Luís René. *The United States and Cuba: Possibilities for Trade Relations in the Nineties?*. Texas papers on Latin America. Working papers of the Institute of Latin American Studies. University of Texas at Austin, ISSN 0892-3507, 1992. (En Inglés)

Economic Intelligence Unit, The. Country Report: Cuba, 2003.

Gallego, Franciso A. and Hernández, Leonardo F. *Macroeconomic Effects of Capital Controls: The Chilean Experience During the 1990s*. Available at

<http://www.bcentral.cl/esp/estudiopublicaciones/estudios/documentostrabajo/pdf/dtbc/203.pdf>.

Hernández Catá, Ernesto. *The Fall and Recovery of the Cuban Economy in the 1990s: Mirage or Reality?* The International Monetary Fund. April 2001.

Initiative for Policy Dialogue. *Backgrounder: Capital Controls*. Available at http://www-1.gsb.columbia.edu/ipd/j_capitalcontrols.html.

Jatar-Hausmann, Ana Julia. *The Cuban Way: Capitalism, Communism and Confrontation*. Kumarian Press, Inc. 1999.

Kaplowitz, Donna Rich. *Anatomy of a Failed Embargo: U.S. Sanctions against Cuba*. Boulder, Co. 1998.

Lago, Armando M. *An Economic Evaluation of the Foreign Investment Law in Cuba*. Available at <http://www.lanic.utexas.edu/la/cb/cuba/asce/cuba2/lago.html>.

Leyva de Varona, Adolfo. *Propaganda and reality: a look at the U.S. embargo against Castro's Cuba*. Miami, FL. 1994.

Montreal, Pedro. *Development Prospects in Cuba: An Agenda in the Making*. (Compilation of essays). Institute of Latin American Studies. London, 2002.

Mission of Norway to the European Union: Policy Areas. Available at <http://ud2.mogul.no/cgi-bin/wbch3.exe?d=4868&p=2238>.

Norway Country Report. 2000 Country Reports on Economic Policy and Trade Practices. U.S. Department of State. March 2001. Available at <http://www.state.gov/documents/organization/1627.pdf>.

Norway's Tax System. Ministry of Finance. Available at <http://www.dep.no/fin/engelsk/p4500279/index-b-n-a.html>.

Pérez-López, Jorge F. *Foreign Investment in Cuba in the Second Half of the 1990s*. Available at http://www.cubasource.org/pdf/perez_DFICuba.pdf.

Pew Initiative on Food and Biotechnology, The. U.S.-Cuba Biotech Scientists Reach Across Political Divide. Internet Article. <http://pewagbiotech.org/newsroom/summaries/display.php3?NewsID=315>.

Sánchez, Jorge Mario. *The Cuban Economy: Problems, Politics, Perspectives*. International Symposium, September 1999.

United Nations Conference on Trade and Development. *Foreign Direct Investment Inflows, in individual countries*. Available at <http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2110&lang=1>.

Werlau, María C. *Foreign Investment in Cuba: The Limits of Commercial Engagement*. Available at

<http://www.lanic.utexas.edu/la/cb/cuba/asce/cuba6/57Werlau.fm.pdf>