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The Cuban Monetary and Financial Jigsaw Puzzle (ARI)

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Theme: The 2008-09 balance of payments crisis and a succession of errors in economic policies have resulted in new monetary and financial complications in the Cuban economy, to be added to the costs and distortions of currency duality.

Summary: The Cuban economy currently operates with two local currencies –the Cuban peso and the convertible peso, both with convertibility problems and multiple and overvalued exchange rates– and has been subject to a banking crisis since 2009. It is a veritable monetary and financial jigsaw puzzle. In order to do away with the dual currency and overcome financial imbalances, monetary policy must devalue the two domestic currencies. Cuba's banks are facing a systemic liquidity crisis with no lender of last resort to help them out of it. The country cannot access a last-resort loan from the IMF, the World Bank or the IDB since it is not a member of these institutions. The government has been applying a tough adjustment policy which has led to the reduction in the fiscal deficit and to a surplus in the balance of payments, which has served to pay off debt and gradually unfreeze bank accounts, although the matter is far from being fully settled.

Analysis: Cuba's monetary and financial policy has recorded significant achievements in the last two decades. Existing inflation was halted at the start of the 1990s, the financial system was developed and inroads were made towards the de-dollarisation of the economy. The elimination of the dual currency remained outstanding.

The balance of payments crisis in 2008-09 and a succession of mistakes in economic policy have resulted in new monetary and financial complications to be added to the costs and distortions of currency duality. The Cuban monetary and financial scene is currently reduced to an economy based on two currencies –the Cuban peso and the convertible peso, both with convertibility problems and with multiple and overvalued exchange rates– and has been subject to a banking crisis since 2009.

The currency duality and its exchange and financial repercussions have formed part of an economic policy of a discretional nature, with a lack of transparency, weak institutions and an excessive amount of prohibitions. Over the last two decades, the Cuban centralised state economic model has undergone several reform and counter-reform processes. The design of the Cuban model likewise exhibits characteristics that have developed as a response to the need to outwit the restrictions imposed by the US embargo.

Within what the government itself has come to call 'a handmade economy', the monetary and financial perspective presents a veritable jigsaw puzzle, not only for those becoming acquainted with the Cuban economy for the first time, but it is also hard to decipher for

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foreign businessmen and investors operating in Cuba and even for the very designers of the economic policy.

Monetary and Financial Achievements

In the second half of the 1990s, Cuban economic policy was able to control the three-digit inflation that had emerged at the beginning of the decade as a result of the crisis and macroeconomic imbalances. Among the main factors contributing to the stability of prices were the freeze on nominal wages, the reduction in the fiscal deficit from 30% to 3% of the GDP, the control of the money supply, exchange rate stability and the encouragement of partial dollarisation. Furthermore, a significant number of structural transformations were implemented that proved to be valid by rescuing from recession a country that had remained isolated after the disintegration of the USSR. Among them should be highlighted the promotion of foreign investment, tourism, individual enterprise and the entry of remittances, in addition to greater decentralisation of the State’s corporate management.

This decade also witnessed the establishment of the two tiers that replaced the former single bank system. In 1997 the Central Bank of Cuba was created, which led to the development of the financial system, while inflation continued to be controlled. Following the Basel I convention rules, the regulation and supervision of State commercial banks and other national and foreign financial institutions was put into practice, which gradually grew alongside credit, savings and greater variety of financial services and instruments. Seven State commercial banks and one investment bank underwent modernisation and capitalisation and gradually became part of the domestic economy and of the international markets.

After several years of monetary stability and financial development, in 2003-04 the Central Bank of Cuba began a series of initiatives designed to de-dollarise the economy. It was decided that dollarised State enterprises should convert their bank accounts to convertible pesos. A premium of 10% was charged to the population and to tourists for cash dollar exchanges. Another initiative involved the announced exchange rate revaluation, granting a period of a few weeks for people to adjust wages to the incentive. Furthermore, the Central Bank established a national commitment to future revaluations in the two domestic currencies. The domestic holding and circulation of dollars and other currencies was not banned. In fact, part of the population and foreign investors have maintained their foreign currency accounts in Cuban banks.

These measures resulted in the inflow of cash dollars dropping from 80% to 30%, with a marked increase in incoming euros. Likewise, the population’s bank accounts in dollars underwent a drop of 57%, whereas accounts in convertible pesos increased by 200% and those in Cuban pesos by 35%.

Double Currency and Multiple Exchange Rates

The Cuban peso has been the historical national currency since it was launched in 1914. Interestingly, those years also had a dual currency, as the US dollar was also used domestically as a means of payment. In 1948 the dollar lost its applicability in domestic transactions. In 1961 the revolutionary government legally penalised dollar holdings, which remained in force until 1993, when the economy became dollarised once again.

The Cuban convertible peso (CUC) was issued for the first time in 1994 at a par with the US dollar. The issue of convertible pesos was subject to a cash conversion system: every CUC in circulation was matched by one dollar in reserves in the Central Bank. The exchange rate of the convertible peso to the US dollar was kept at a par until it was re-valued by 8% in 2005. At first, the circulation of the convertible peso was minimal and restricted to a small segment of the population, until it replaced the dollar in State enterprises in 2003.

The dual currency in the period 1993-2003 was marked by the simultaneous circulation of the Cuban peso and the US dollar. From 2004 to the present, its hallmark has been the parallel circulation of the Cuban peso and the convertible peso. Official plans for the elimination of this dual currency seem to point to a transition of convertible peso activities towards the reinstatement of the Cuban peso as the only monetary unit. However, the existence of multiple exchange rates for these currencies renders it a highly complex undertaking.

The current exchange rate for the local population and tourists at the Cuban exchange bureaus (CADECA) is of 24 Cuban pesos per convertible peso, whereas the official exchange rate for corporations and institutions is of one Cuban peso per one convertible peso. The latter are banned from dealing with the CADECA and engage in arbitrage of exchange rates, which in and of itself is already hard to do as these exchange bureaus only deal in small cash amounts.

Where does this currency exchange rate duplication stem from? The 1980s saw the establishment of the official exchange rate of one Cuban peso per one US dollar. Since its introduction in 1914, the national currency had experienced several exchange systems, some of which allowed fluctuation, but never venturing far from parity. At the beginning of the next decade, amid the crisis and macroeconomic imbalances, the informal market devalued the Cuban peso to over 100 pesos per dollar. When CADECA was created in 1995 it took the informal exchange rate as the reference rate. This gave rise to the two institutionally-accepted exchange rates for the Cuban peso in relation to the US dollar and the convertible peso, one for the local population at the exchange bureaus and another official rate for enterprises and institutions. Table 1 summarises current exchange rates:

Table 1. Cuba: currency exchange rates, 2010

	Population and tourists (CADECA)	Enterprises and Institutions (Official)
Cuban peso/convertible peso	24	1
Convertible peso/US dollar (b)	0.92 (a)	0.92
Cuban peso/US dollar (b)	22.08(a)	0.92

(a) Additionally, a charge of 10% is applied to cash currency exchanges.
(b) The exchange rate with the euro and other currencies varies daily according to the value of the dollar in the international market.
Source: the author.

The deferred devaluation of the official rate of the Cuban peso, coupled with the vast gap (2,300%) lying between it and the rate for the population and tourists, is the toughest part of the monetary jigsaw puzzle faced by the government in its plans to remove the dual currency.
The costs of the dual currency are expressed, in the first place, in the distortive effect that the overvaluation of the official rate of the Cuban peso has over economic measurements, as well as on all decisions and resource allocations arising thereof at both a business and fiscal level. Secondly, this exchange rate prevents the extension of convertibility of the Cuban peso to businesses and institutions. Non-convertibility creates an absurd segmentation between businesses operating in Cuban pesos and those who do so in

convertible pesos. This leads to the weakening of the domestic market and to the reduction of links with foreign investment and the foreign markets.

There exists a current consensus in the government regarding the need to overcome all these costs, although no consensus seems to have been arrived at regarding how do move towards the convergence of the two rates.

The crisis and inflation at the start of the 1990s led to a drop of over 70% in actual State wages, which have not yet recovered. The structural changes of this decade, greater opportunities to obtain foreign personal income and the increase in unlawful economic activity, have enabled households to access sources of income other than the wages from State-owned businesses and institutions. It so happens that in the partial dollarisation process, State wages were in Cuban pesos, whereas these other income sources were mostly obtained in dollars, leading to the popular misconception that the dual currency is the cause of inequalities. This poses an additional problem for the government's monetary unification plan.

The Financial Crisis of 2009

In 2008-09 the Cuban economy faced a balance of payments crisis triggered by three external adverse factors. First, the drop in the terms of trade (-31.6%) due to the decline in the price of nickel (the main export product) and the increase in the cost of oil and food. Despite having unproductive arable land, Cuba currently imports 80% of its food. The second shock came from a disastrous hurricane season which forced it to resort to additional food imports, as well as to supplies for the repair of housing and infrastructures. The third adverse factor was the global crisis and its repercussions on exports and external financing.

Sustainability in the balance of payments equilibrium had long been undermined by a growth model based on the export of professional services with a low multiplying effect. Since 2004, the export of physicians to Venezuela grew to treble the income from tourism, but failed to establish relevant connections with the domestic economy. This was a period of stagnation in industry and agriculture, with a rise in imports, a widening in the goods deficit and an increase in foreign debt. When this professional services sector began to lose dynamism and reached the potential level of available physicians, the economy reached a situation of low growth and greater foreign dependency.

The impact of external events on a fragile balance of payments resulted at the end of 2008 in the default of part of its foreign debt commitments. In 2009 the financial situation was further aggravated by the banking crisis. Cuban banks were forced to freeze foreign currency bank accounts from foreign investors and suppliers. The loss of convertibility of the convertible peso damaged companies with accounts in this currency. Since 2009, the country has no foreign currency to sustain the convertibility of the CUC and the overall operation of the payments system.

The cause of the banking crisis does not lie in a massive deposit withdrawal. The bank accounts of the population and the exchange bureaus have not been affected by the banking crisis and the loss of convertibility of the CUC. The causes are rooted in the balance of payments crisis and in the systemic risks to which the banks were exposed as a result of the series of monetary decisions that led to the de-dollarisation.

One of the risks was caused by the removal in 2003 of the conversion system that controlled the issue of convertible pesos, without having established a replacement monetary system. Furthermore, the fiscal deficit statistics and the monetary offer of convertible pesos remained invisible even for the National Assembly, which at least does have knowledge and grants approval every year to the fiscal deficit and the monetisation in Cuban pesos. Although the data are not publicly available, the facts show that by 2009 the amount of CUC issued was well over the foreign currency reserves required to back convertibility.

The year 2005 saw the creation of the Single State Account as part of a counter-reform process that included financial centralisation. Companies were forced to transfer foreign currency and convertible peso surpluses to the Single Account. On the one hand, the creation of this Single Account meant a larger concentration of banking risk in the central government's finances. On the other, by locating and managing the Single Account in the Central Bank, the autonomy of the latter to manage the currency offering based on monetary policy criteria was undermined. The Central Bank began to carry out fiscal duties not germane to the objectives of an issuing institution.

Another systemic risk was generated by the overvaluation of the convertible peso. Since its exchange rate was re-valued at 8% in 2005, it has remained stable despite fragilities and subsequent imbalances in the balance of the payments. As such, Cuban monetary policy suffered at first hand the classic mistakes made by innumerable central banks in past decades: excess of discretional powers, lack of transparency and public scrutiny of monetary decision, monetisation of the fiscal deficit, subordination to fiscal policy and overvaluation of a fixed exchange rate. All this gave way to an unidentifiable systemic risk on the banks' individual balance sheets and caught national and foreign businessmen by surprise.

Conclusions

Putting Together the Jigsaw Puzzle
In order to eliminate the dual currency and overcome financial imbalances, monetary policy must devalue the two domestic currencies. Efforts must also be made to correct the design errors in monetary policy that gave way to the systemic risks and triggered the financial crisis of 2009, in order to prevent the same pattern from being repeated in the future.

Since the end of 2009, instead of devaluing the convertible peso, the Central Bank has been applying the 'handmade economy' model, having issued a new instrument known as the Liquidity Certificate (LC). The LCs indicate which convertible pesos are actually backed by foreign currency in order to pay for imports and meet other foreign payments, and which are only suitable for domestic payments.

Either one of these partial solutions complicates the Cuban monetary and financial jigsaw puzzle even further and makes monetary unification increasingly unlikely. The CUC must be devalued for it to become convertible once again. Without a convertible currency, the business and banking system cannot become part of the world economy and run the risk of returning to dollarisation.

On the other hand, the devaluation of the official exchange rate of the Cuban peso continues to be delayed. The elimination of the dual currency is a process that will take several years due to the huge gap between the multiple exchange rates. But the longer the devaluation of the official rate is delayed, the further away the date will be on which the economy will be able to have a single currency once again.

Both the devaluation of the convertible peso and the Cuban peso will pose economic policy challenges. First of all, due to the probable currency mismatches in the balance sheets of banks and businesses. Secondly, the business structure, mostly monopolistic, could transfer the currency rate in full to prices thus annulling the effect of a real devaluation.

Nevertheless, the challenges must not make us forget the benefits of having convertible currencies with rates of exchange that will render the economy more transparent, considerably improve the allocation of resources, benefit the export sector, strengthen the domestic market and bring the country closer to monetary unification.

The financial jigsaw puzzle is as hard, or even harder, than the monetary one. Cuban banks are facing a widespread liquidity crisis without a lender of last resort to help them overcome it. Although information on international reserves is not public knowledge, the facts show that the crisis found the Central Bank with insufficient reserves to back liabilities in convertible pesos and foreign currency. In the absence of a national lender of last resort, the bank needed an international one.

The effects of the global crisis in Venezuela have made impossible a financial rescue from its main economic ally. Neither have loans come from China, Russia or Brazil, to give the financial system some breathing space. In fact, the extension of the liquidity crisis has led to a confidence crisis, making it difficult for the banks to get any financial funds. At this stage, the price to be paid in terms of credibility and the setback of part of the financial system achievements of the 1990s are inevitable.

The country has no access to a loan of last resort from the IMF, the World Bank or the IDB, as it is not a member of these institutions. If Cuba were a member, it could be eligible for a loan of this kind which usually requires an adjustment to be made in order to recover macroeconomic balance and structural changes.

In 2009, the government implemented a 37.3% adjustment in imports and a 16% cut in investments and reduced the fiscal deficit in Cuban pesos from 6.9% to 5% of the GDP. For 2010 and 2011, an additional reduction in the fiscal deficit is expected on the basis of a risky drop in State employment of more than one million employees (over 20% of the economically active population).

The economic adjustment policy is pro-cyclical but seeks to favour long-term growth by contributing to monetary and financial stability. The reduction in the fiscal deficit in Cuban pesos has helped to keep inflation under control. The adjustment in imports has helped generate a surplus in the balance of payments, used to start paying off debts and to gradually unfreeze bank accounts, although the matter is still far from being completely settled.

Some inroads have been made in terms of structural changes. The government is seeking to increase real State wages, replace imports and give growth a new boost, although the extent to which the centralised state model is to be transformed is largely unknown. In 2010 the intention to encourage freelance enterprise and support micro-businesses and cooperatives was made known. That same year saw the extension of the surface right of foreign investments from 50 to 99 years so as to promote golf courses and other real estate investments. Previously, progress had been made in the handing over of State-owned land not in production to private individuals, restrictions on the access by Cubans to hotels and mobile telephone services had been lifted and the setting of salaries in State enterprises became more flexible.

It is evident that the jigsaw puzzle must be put together gradually. Insofar as the new pieces are put in their proper place, the rest of the picture will seem clearer. Adjustment and structural changes are two pieces that fit together perfectly if a suitable balance and proper time orchestration is achieved between them. Devaluation of the currency rates is a piece in the middle of the whole picture. If the economy were to be granted a loan of last resort or should benefit from positive outside events, such as the drilling and discovery of oil in Cuban waters in the Gulf of Mexico or the lifting of the restrictions on visits to Cuba by North American citizens, then it would all become much easier. The jigsaw puzzle will never be put together completely unless a deep and definitive transformation of the centralised state model is carried out.

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