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Toward currency and monetary unity

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The origins of the current dual currency system can be traced back to the 1990's, following the fall of the Soviet Bloc and, consequently, the loss of Cuba's main trade partners. These events represented a severe external shock that rattled the Cuban economy. One of the initial consequences was the alarming macroeconomic upheaval the country underwent: the fiscal deficit rose to an annual average of 24.9% of GDP between 1990 and 1993; private liquidity reached 67% of the GDP; forced savings[1] rose due to prices in the regulated market not being adjusted, and hyperinflation reached the triple-digits.

These unbalances immediately caused a significant loss in the purchasing power of the national currency. This element and the increased flow of dollars from tourism and remittances created a favorable atmosphere for a *partial dollarization*[2] of economy. In light of this complicated situation, the authorities opted to institutionalize *partial dollarization* in 1994 by establishing a dual monetary scheme in which the Cuban peso and the US dollar legally shared the function of money.

For the next 20 years, the monetary scheme maintained a series of *sui generis* characteristics, particularly the sharp segmentation of markets by currencies, by currency exchange systems and by the type of agents involved, making it possible for this mechanism to go beyond fulfilling monetary-financial functions. It has become an instrument to conduct fiscal policy in Cuba by capturing and later distributing foreign currency amongst the different sectors of economy in a discretionary and highly centralized manner.

The adoption of this measure generated an intense academic debate in the 1990s. Seen in hindsight, it could be said today that dual currency circulation made it possible to solve short-term problems because it contributed

1 Forced saving by the population was offset by an equivalent dissaving in the public sector. The former went from 16% of GDP in 1989 to 47% in 1993 while the latter decreased from 6% of the GDP to -47%. See Escaith (1999): *"Creación monetaria en Cuba y sobreliquidez: un enfoque de circuito"*.

2 A phenomenon understood to be the spontaneous substitution of domestic currency by a foreign currency in one or more of its functions.

to a non-inflationary growth of the economy[3] and to better control the fiscal and current accounts deficits based on earnings from markets operating in dollars; it also allowed for a quick emergence of a "competitive atmosphere" (with prices and costs falling in line with the international market) in those market segments directly involved in the foreign currency market by insulating it from the monetary unbalances associated with the Cuban peso. It also provided a transfer system to support the least favored sectors, thereby buffering the recessive effects of financial restructuring measures.

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However, after 20 years of little modifications[4] or corrections of its most controversial points, the dual currency has also brought the development of significant burdens with marked negative effects for the country's economic performance. Without a doubt, the costs associated with the overvaluation of the so-called *official exchange rate* for the entrepreneurial and public sectors are the most alarming, wherein one convertible peso equals one Cuban peso.

The absence of an economically-backed exchange rate capable of connecting and reflecting the financial flows in pesos, dollars and convertible pesos in an economy in which these currencies circulate, seriously compromises any economic profitability indicator (solvency, profitability, situation of patrimony, feasibility of investment projects, comparative analysis in order to assess the possibility of substituting imports, etc.). Furthermore, this distorts relative prices by taxing the country's exports and making imports cheaper. Hence, it generates an inefficient allocation of financial resources by transferring them from profitable enterprises to unprofitable enterprises[5] and prevents a correct analysis of the state of public finances in view of the coexistence of two parallel fiscal instruments: the State Budget and the Central Financing Account.

MOVING TOWARDS ONE SINGLE CURRENCY.

The recently announced measure, and undoubtedly one of the most anticipated ones, of the beginning of preparatory work to move to monetary and exchange unification, has captured everyone's attention in Cuba.

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3 Growth was based in a dollar-dependent accumulation pattern which guaranteed availability of actual resources.

4 The most transcendental change of the dual monetary scheme took place after the de-dollarization process experienced by Cuban economy between 2003 and 2005. The circulation of the dollar was replaced by the Cuban convertible peso (CUC) in transactions between enterprises and retail markets. Although this measure postponed the elimination of monetary and currency exchange duality, it at least allowed the Central Bank to monopolize the issuance of the two currencies that were circulating in the territory, thereby enhancing its autonomy. For further details, see Vidal (2006): "*Estabilidad, desdolarización, y política monetaria en Cuba*".

5 Two sources have caused this problem: firstly, the centralized mechanism for the appropriation of foreign currency grants financial resources captured by the State's Central Financing Account to low-efficiency enterprises. Because of the relevance of their social object, said enterprises must continue to operate; secondly, the granting of credits by the banking system is conducted on the basis of the financial-economic situation of enterprises; the distortion of their situation generates an inefficient allocation of financial resources (non-profitable enterprises might seem profitable depending on the exchange rate).

The recent announcement of the start of preparations for monetary unification entails a group of positive aspects, including the following:

- The government ratifies its decision to advance towards monetary and foreign exchange unity.
- It also ratifies that it will start in the entrepreneurial sector.
- It guarantees the citizens' savings in Cuban convertible pesos (CUC).

However, areas of conflict and tensions may in turn exist, for example:

- High expectations of immediate improvement by the population versus real effects of unification.
- Erroneous identification of low purchasing power of salaries with the dual currency.
- Exchange mismatches at the enterprise level.
- Inflationary pressures among different types of markets.
- Pressures on taxation.

Some of the positive medium-term effects will undoubtedly be the following:

- Greater transparency in relations between economic agents and the State (including IED).
- The establishment of real accounting.
- Improved efficiency in the allocation of resources.
- Possible positive impact on medium-term growth.

In order to have success in this field, some experiences indicate that the following measures will be vital:

- ***Maintain convertibility in both directions:*** This will generate confidence in the public and enterprises.
- ***Decide on the magnitude of the rate***: There is no doubt that this is a controversial issue because disparities are quite huge (one dollar for one Cuban peso and one dollar for 25 Cuban pesos; the differential is 2,400%, unprecedented in the entire world). It will be necessary to confront the tendency to meet popular expectations of substantial improvements in the purchasing power of the Cuban peso by reevaluating the CADECA (foreign currency exchange agencies) rate. A rate excessively close to the official rate would limit the desired effect on efficiency and productivity, as well as on the exporting sector. It would lead to tensions on the supply side in the domestic consumer market, possible shortages and subsequent devaluations with the consequent creation of uncertainty, and a renewed loss of confidence in the national currency.
- ***Avoid the emergence of multiple sectoral rates and eliminate the existing ones***: The multiplicity of rates has been common practice in national economic management as part of excessive discretionality; its counterpart has been spurious rents for benefiting sectors and "fines" on efficiency and productivity in the case of non-benefiting sectors. In fact, the "certificate of liquidity" popularly known as CL is the ultimate expression of said discretionality; in practice, it operates as a sectoral rate but also as "punctual" rate throughout time and it has been the mechanism used to grant purchasing power in "hard currency" to state enterprises. The granting of said purchasing power does not depend at all on the actual performance of the enterprise, its efficiency or productivity.
- ***Decide on the exchange regime***: This is an issue of far-reaching importance: current practice indicates that floating rate regimes show better results. In the case of Cuba, the closest experience was the floating margins of the unofficial rate (CADECA) until 2004 when it was suppressed and a fixed rate regime was adopted.

- ***Address increasingly important variables henceforth:*** *inflation*. After the inflationary peak at the beginning of the 1990s, inflation has remained relatively low in the country. The devaluation of the official exchange rate could generate important pressures in all markets. In this regard, international experience speaks in favor of setting inflation targets, and logically, enforcing them.
- ***Find fiscal supports to cope with possible monetary mismatches:*** in enterprises and setting temporary limits for those supports. No doubt, this will be decisively important not only as an alternative to multiple exchange rates but also as an instrument to initially "protect" enterprises that could experience significant foreign exchange mismatches, that is, losses due to variations in the exchange rate.
- ***Avoid deficit monetization and fix limits to public indebtedness***: Deficit monetization has been common practice in fiscal management; however, monetization may become a factor in unleashing inflationary processes under conditions of foreign exchange and monetary unity. Hence, fiscal discipline would be decisively important.

STEP-BY-STEP APPROACH OR SHOCK CURE?

The impossibility of receiving financial support from multinational institutions such as the World Bank and the International Monetary Fund due to extraterritorial restrictions imposed by the decades-old U.S. blockade (embargo) practically excludes the implementation of any type of shock cure from all possible options.

If the data provided by the "The Economist Intelligent Unit" is accepted, the country's foreign currency reserves today amount to close to 4.7 billion dollars, the equivalent to some 4 months of imports.

Annual data and forecast (The Economist Intelligent Unit)

	2012b	**2013b**
Nominal GDP (US$ m)	63.673	66.451
GDP per head (US$ PPP)	11.313	11.811
Trade balance (a)	-7.747	-7.677
Service balance	9.255	8.917
Current Transfer balance	846	938
Current Account balance	-134	-95
Debt stock	22.512	23.442
Debt service paid	2.514	2.479
Total Interenational Reserve	4.693	4.743

(a) 2012 actual; (b) EIU estimates

This financial constraint is one of the strongest limiting factors preventing any attempt at a "shock cure". On the other hand, the costs of a "step-by-step" process must be considered. These costs involve particularly the extension of distortions, the delay in clarifying the actual situation with respect to the efficiency and productivity of enterprises, the possible emergence of arbitrage opoortunities, etc. However, the impossibility to access significant external supports, and external financial constraints, leave no other alternative but to opt for a step-by-step process.

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The harmful influence of currency exchange unbalance[6] complicates the macroeconomic environment in which the entrepreneurial and public sectors in Cuba perform. For this reason, the monetary unification process should start by implementing a devaluation that leads towards foreign exchange adjustment. Nevertheless, this measure generates great uncertainty in view of the little experience our country has in determining the effects of this type of policies[7], and in view of current vulnerabilities, namely the extended presence of mismatches and exchange rates subsidies affecting a large part of economic agents.

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The expected effects of devaluation are similar to those expected in any market economy: a weakening of the economic-financial situation in enterprises having exchange mismatches (balance sheet effect); increased competitiveness by the exporting sector and more expensive imports; increased prices due to a more expensive import component or in Cuban convertible pesos (CUC) of many products, which might be passed on to consumers, thereby deteriorating real salaries if this does not go hand-in-hand with a salary reform measure, among others.

The main economic policy challenge will be the preparation of a sufficiently creative and comprehensive unification timetable which is adapted to the peculiarities of Cuban economy.

It is quite difficult to predict whether positive or negative effects will prevail. Nevertheless, the mere fact of having greater transparency in the cost and price structure is reason enough to immediately implement this measure.

The main economic policy challenge will be the preparation of a sufficiently creative and comprehensive unification timetable which is adapted to the peculiarities of Cuban economy. With this purpose in mind, compensatory instruments should be used to potentiate the positive effects of the unification process, particularly devaluation, and to buffer or manage unavoidable negative effects.

A set of measures should accompany the unification; it is that set of measures that will make it possible to adequately manage this process.

6 It was acknowledged by scholars, economic authorities and leaders of the country many years ago.

7 The exchange rate variable has never been adjusted during the entire revolutionary period.

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Dr. Triana has written more than twenty books as author and co-author on issues related to the Cuban Economy and Economic thought. He has published more than 40 articles in books and magazines edited in Cuba and abroad and he has participated in numerous national and international events related to the Economic Development of the Cuban Economy. He has been travelling professor and US, Canada, British universities, as well as in other countries in Europe.

He has received the following recognitions for his scientific work:

National prize in Social Sciences in 1996 from the *Ministerio de Ciencias, Tecnología y Medio Ambiente de Cuba*, as co-author.

National prize in Economics “Raúl León Torras” 2002, *Asociación Nacional de Economistas de Cuba.*

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