LATIN AMERICAN NEWSLETTERS

latin american **white paper**

Cuba's dual currency system

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Why it must change and what could replace it

In early July 2013, Marino Murillo, Cuba's economic tsar and architect of its economic policy 'updating', addressed an invited delegation of international journalists and academics about the direction of the economic reforms being undertaken by the government led by President Raúl Castro. Among much else, Murillo confirmed that the government is looking to unify Cuba's two currencies.

In this *Latin American White Paper*, Dr. Emily Morris and Andrew Hutchings examine the current economic and political situation in Cuba and put forth proposals for currency reform in the context of the Cuban government's tentative moves to address this key issue, often identified as the 'elephant in the room' for Cuban economic policymakers.

Summary

- The absence of proper money is the most fundamental weakness of Cuba's economy. At present neither the convertible peso (CUC) nor the national peso (CUP) serve as a wholly satisfactory measure of value. Neither do they serve as a medium of exchange, nor as a unit of account. Reform of Cuba's dual currency system will require much more than a devaluation of the CUC and a revaluation of the CUP, so that they are notionally of equal value. Whatever replaces the dual currency system needs to be stable and robust, and to be seen as such.
- A currency peg system administered by a formally constituted monetary board - similar to that which has worked well in Hong Kong since 1983 - appears to be a logical alternative. We argue that Singapore would also stand out as a country where a modified currency peg has contributed usefully to very strong economic performance and where the government has ensured that the gains are very widely (if not totally evenly) spread across the population.
- In the short-term, currency reform will create winners and losers among Cuban households. However, over the medium-to-long term successful reform should generate tremendous benefits for all Cubans. If managed properly, it could support the ongoing rule of the ruling Partido Comunista de Cuba (PCC) within a country that is far richer than it is today.

Introduction

Cuba's dual currency system, which uses the Cuban peso (CUP) and the 'Convertible peso' (CUC), cannot be sustained indefinitely. It produces massive distortions to incentives to work and the labour, goods and capital markets, and severely damages Cuba's international competitiveness.

Preparations for currency adjustment to date have taken place at a gradual pace, with policy aimed at steadily increasing the use of the CUP by expanding the availability of goods and services in CUP markets, in order to create the conditions for eventual currency unification. This approach aims to minimise the disruptive shock of the necessary adjustment, but the lack of urgency suggests that the costs of further delay are being underestimated relative to the risks of a swift adjustment. Analysis of the relative costs and benefits of more rapid exchange rate unification suggest that it should be the main priority for economic adjustment now, ahead of further liberalisation.

Once unification has been achieved, the authorities will face a further challenge: how to manage the new currency to adequately perform the functions of money. Of the choices available to Cuba, a currency peg, run by a currency board, appears to be the most logical solution. However, this new currency would need to be underpinned by substantial reserves. In order to raise the necessary reserves, one possibility would be a bond issue. To understand the significance of such a move, and its potential institutional implications, it is useful to look at how other countries have managed their currencies. In particular, Singapore provides an interesting model for comparison.

1. CURRENT SITUATION: THE DUAL CURRENCY SYSTEM

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Currencies and exchange rates:

During the severe economic crisis caused by the collapse of the Soviet trading block in the early 1990s, the fully-monetised fiscal deficit ballooned and the value of the Cuban peso (CUP) relative to the US dollar on the black market plummeted, from around 7 CUPs to 1 dollar in 1990 to more than 120 to 1 in 1993. From 1993-95, the government introduced stabilising measures and a number of structural reforms. Among these were the legalisation of the holding of US dollars in 1993, followed by the creation of the 'convertible peso' (CUC), a new currency to circulate within the domestic economy as a US dollar equivalent. While the official rate of exchange between the CUP and CUC was 1:1, a legal second rate, known as the 'Cadeca' (Casas de Cambio) rate, was introduced for personal transactions. This rate was determined by supply and demand, and therefore successfully eliminated the black market. Stabilisation and reform resulted in the appreciation of the CUP, to CUP25:US$1 by the end of 1995. It fluctuated around that level for a decade.

In 2004, the US dollar was withdrawn from domestic circulation, leaving only two currencies in circulation within Cuba: the CUP and the CUC. The CUP can only be exchanged for CUCs, and since March 2005 the rate has been fixed, at CUP24:CUC1. The CUC can be exchanged for foreign currency within Cuba, but is not convertible outside the island.

The current system therefore consists of two currencies, with two exchange rates:

The value of the CUC is fixed at par with the US dollar. This valuation is broadly in line with a market rate, in terms of the pricing of imported goods in domestic state-owned CUC stores. However, the lack of flexibility means that it is unresponsive to demand fluctuations in competitive international markets. This is a particular difficulty for Cuba's tourism industry.

The CUP has two values:

- the 'official' exchange rate, used by state entitites, of CUP1:CUC1; and
- the Cadeca rate, originally only available to households for personal transactions but now also used by the growing private sector, of CUP24:CUC1.

2. COSTS OF THE CURRENT SYSTEM

Effects on real incomes

The dual exchange rate system is the main reason for Cuba's 'upside down' pattern of income distribution. Precise measurement of relative real incomes is difficult, however, due to state controlled prices for basic goods.

In the state sector, wages are paid in CUP. The average monthly state salary is CUP460. The top CUP salary is around CUP2,000. At the Cadeca rate, the average monthly state salary can be exchanged for just CUC19.2 (US$19.2), and the top salary for a modest US$83.3. However, for a Cuban household there is not a linear relationship between CUP and CUC values, because of the relatively high purchasing power of that part of CUP income that is spent on subsidised goods (including basic foods, medicines, school supplies etc) and services (including pre-school child care, transport, and housing costs). Therefore, the US dollar purchasing power value of the first CUP400 of monthly household income (a very rough estimate of the amount spent on subsidised goods and services) is generally even more than US$400, but the value of the next CUP400 is closer to US$19.

Most Cuban state employees also receive some part of their monthly income in the form of a CUC bonus, or gifts in kind. These usually range in monthly value from around CUC5 to CUC30.

In the non-state (formal and informal) economy, incomes range enormously. These can be denominated in CUP or CUC: it is becoming custom to use the two currencies interchangeably for private sector trading and wage-setting, using the Cadeca rate. At the lower end, it appears that some employers are offering incomes around the level of state salaries – just CUC1 a day – enough for subsistence thanks to state subsidies for basic goods and services. At the upper end, there are reports of incomes of over CUC4,000 per month: 100 times the average state salary in nominal terms, and more than 10 times the average salary in real terms.

3. ECONOMIC DISTORTIONS

(i) Labour market and incentives

Clearly, the current system provides weak material incentives for state sector workers, and encourages the movement of labour from the state sector to the non-state (formal and informal) sector, where real incomes can be so much higher.

State sector labour market. Real pay levels in the state sector have been so low for so long that a very large number of state employees have developed a huge range of ways to supplement their incomes, many of which involve the theft of paid labour time and effort, or of equipment or supplies from their employer. Accurate measurement of the cost of the many forms and types of such activity is impossible, but there is no doubt that absenteeism is high, work time at the workplace is used for other activities, labour discipline is weak, and losses throughout the supply chain (that is, leakage into the black market) are endemic. As a result, average labour productivity — which is already severely depressed due to a severe lack of investment for more than two decades — is damaged.

A particular problem with the migration of workers from the state to non-state sectors is the movement of skilled labour. Skilled workers who leave their state sector jobs represent an internal 'brain drain' for the economy as a whole. This includes professional skills, which have not yet been included in the list of activities permitted for non-state businesses. International migration is also particularly enticing for skilled professionals, particularly since the US provides Cubans with privileged status in terms of the right to work there.

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Non-state labour market. In the growing non-state sector, the undervaluation of the CUP at the Cadeca exchange rate is encouraging the growth of many activities that earn CUCs, but have extremely low levels of labour productivity. This is because the new self-employed (including skilled workers) can survive on earnings of just CUC1 per day, thanks to the state subsidy they appropriate when they exchange their salary for the undervalued CUP.

The exchange rate distortion therefore means that the process of shifting employment from the state sector to the non-state sector may fail in its objective of increasing the average level of labour productivity in the economy as a whole. Instead, it may simply exchange the army of subsidised labour in the state sector for a new army of subsidised labour in the non-state sector.

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At the same time, the exchange rate system also provides a subsidy for and therefore incentivises those living on unearned (remittances), and illegally-earned (black market), incomes.

(ii) International competitiveness

The dual exchange rate system depresses international competitiveness in different ways in the state and non-state sectors, due to the peculiar nature of the separation of markets and workings of price subsidies.

State enterprises. In the state sector, which dominates the economy, the dual exchange rate system imposes a high cost in terms of competitiveness. Cuban enterprises engaged in export sales, or import substitution, are severely hampered by the use of the overvalued official exchange rate as the accounting measure. Their profits are reported in CUPs, using the official CUP1:CUC1 rate of exchange to account for CUC revenues from exports. As a result, it is near-impossible even for very efficient Cuban enterprises engaged in international trade (whether exporting or substituting for imports) to show a surplus on their accounts. They will therefore have to apply to the planning authorities for the allocation of foreign exchange for any inputs or capital spending: a cumbersome process, which severely limits their ability to reinvest profits or respond to global market conditions. In effect, administrative controls are substituting for price signals throughout the supply chain, generating delays, waste, inefficiency and frustration.

The inevitable result is that, just to keep production going, enterprise managers will resort to the art of 'resolviendo' – hoarding inputs, setting low targets, paying cash for black-market supplies, or selling off the books to secure hard currency – all of which erode productivity of the state sector as a whole.

The economic restructuring process currently under way aims to increase the autonomy and efficiency of state enterprises. However, for as long as currency dualism persists, state enterprises cannot become autonomous in any meaningful sense, as they need to refer to the planning authorities for the allocation of foreign exchange. In order to devolve economic decision-making, enterprises need to be able to respond directly to price signals from the international market place. That is, they need an exchange rate that enables them to measure performance and generate profits, as well as being given greater control of the allocation of those profits.

A few exporting enterprises, mostly joint ventures with foreign partners, have flourished because they enjoy a privileged position in this respect. Their accounts are presented only in hard currency (US dollars, Euros or CUCs), with Cuban inputs priced lower than the official, overvalued CUP equivalent. Currency dualism blocks the integration of this 'enclave' sector with the rest of the economy.

Non-state activity. For the reasons described above, the non-state activity (formal and informal) that serves the external sector which is mainly limited to the tourist sector is helped by the hidden labour subsidy from the state. A further hidden subsidy comes from remittances from abroad, which provide free start-up capital in many cases. These subsidies mean that the productivity of a large number of businesses in the new and growing private sector is extremely low. When the undervaluation of the Cuban peso comes to an end, they will be loss-making. Those that are unable to adapt will shed employees and face collapse. The longer this situation persists, the more Cubans will become dependent on unsustainable non-state activity.

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4. CURRENT POLICY: EVOLUTIONARY AND CAUTIOUS

One of the objectives of the current process of economic ‘updating’ is the restoration of a single currency system, but so far policy has been hesitant. The reasons for caution are understandable. The recent memory, of a collapse in the black market value of the Cuban peso in the early 1990s, serves as a warning about what might happen if mistakes are made.

Since 2005, the CUP:CUC exchange rate has been fixed at CUP24:CUC1. The long-standing aim of policy is to steadily raise demand for CUPs by increasing the proportion of goods and services sold in this currency within the domestic economy, until conditions are right for unification. However, no hint has been given about the specific conditions that the authorities consider necessary for the move to be made, or the timetable for currency unification. The amount of domestic retail sales in CUPs has been rising, while the limited available balance of payment data (discussed further below) suggests that international reserves are being accumulated in preparation for eventual unification, but there is no apparent sense of urgency. Meanwhile, the distortions and inefficiencies remain, stunting productivity in both state and non-state sectors, and fostering the growth of new inefficient activity.

In the past year, there have been some signs that the authorities may be moving towards the elimination of currency dualism, albeit with great caution and no sign of haste. A formal pilot programme initiated in January 2013 enables transactions between some state enterprises that operate in CUCs (exporting enterprises, mainly in tourism) to use different CUP:CUC rates (reported to be between CUP7:CUC1 and CUP11:CUC1) for their transactions with other enterprises that sell supplies. The suppliers may be state, cooperative or private, and are mainly agricultural. Officials have indicated that the results of this change are being monitored closely. Although they concede that it is not possible to assess the impact of a change in the Cadeca rate at the national level on the basis of isolated case studies, the experiment provides the first clear confirmation that a revaluation is actively being considered.

5. THE IMPACT OF EXCHANGE RATE UNIFICATION: FAST VS. SLOW

Since the Cadeca rate is currently fixed by the authorities, they have the power to change it without delay, but fear of economic disruption and social costs is holding it back. However, a survey of the relative effects of abrupt and gradual unification on competitiveness, foreign exchange flows and relative incomes suggests that greater urgency would be preferable.

As the experiment with direct supplies to tourism indicates, policymakers recognise that exchange rate unification would involve an appreciation of the currently undervalued Cuban peso relative to the convertible peso, from the current Cadeca rate of CUP24:CUC1 to somewhere between CUP11:CUC1 and CUP5:CUC1. If we assume that the chosen rate was CUP10:CUC1, what would the implications of a sudden change be, relative to the current policy of gradual adjustment?

Impact on currency flows

Concern about a possible foreign exchange crisis is misplaced. In the standard textbook account of currency markets, the impact of an exchange rate change on foreign exchange flows is determined by demand and supply. In general, an increase in the value of a currency is expected to reduce exports (that is, the demand for the currency will decline) and increase imports (the supply of the currency to the exchange market will rise). The result is that net foreign exchange inflows will fall; moreover, in anticipation of this trend, there could be a flight from the peso, causing a foreign exchange crisis. But in Cuba's case, the determinants of demand and supply are atypical, making such an outcome extremely unlikely.

There are two main peculiarities of the Cuban exchange market. First, the Cadeca rate only applies to the household and micro-enterprise sectors, and is limited to the domestic economy. Second, within the domestic economy, the markets for basic (state subsidised) and non-basic (non-subsidised) goods remain separated, and administered prices for basic goods remain well below market prices. In the case of non-basic goods, market prices dominate – both in the hard currency (TRD) stores, which mainly sell imported products at international prices plus a retail mark-up, and in the 'free' agricultural markets, which sell goods produced within Cuba at CUP prices that are accepted as interchangeable with CUCs at CUP24:CUC1. In the latter, prices are broadly in line with (although slightly cheaper than) international prices at the Cadeca rate of exchange; and as such, they remain largely prohibitive for CUP-income households.

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Demand for a given currency is determined mainly by the demand for the goods and services produced in the economy. In Cuba's case, though, the restricted use of the Cuban peso and separation of markets within the economy means that the demand for CUPs in Cuba's Cadeca exchange market does not come from Cuba's international trade. Instead, it comes from Cubans with CUCs who want to exchange them for CUPs in order to purchase basic goods and services from the state at administered (way below market) prices. The amount of CUPs that will be bought for this purpose is therefore inelastic: for as long as the CUP prices remain below CUC prices, a rise in the value of the CUP will have no effect on the amount bought.

Indeed, for some relatively low-income CUC-income Cuban households, there may even be an effect similar to the exceptional case of the upward-sloping demand curve of the 'Giffen good': as the rise in the price of the CUP reduces their real income, they may shift consumption habits towards the cheaper market, which is the CUP one. That is, they might even buy more CUPs than before, rather than fewer, by looking for bargains in the CUP markets rather than extravagantly shopping in CUC stores.

On the supply side, CUPs are sold on the Cadeca market by CUP-earners who wish to buy goods and services that are only available in CUCs. These households can only spend the part of income left over after they have already bought their essential goods and services in CUPs. This surplus disposable income does not vary if the exchange rate changes. That is, the supply of CUPs to the Cadeca market is also inelastic.

The lower the elasticities of demand and supply of any currency are, the weaker the impact of an exchange rate appreciation on net flows of foreign exchange. Indeed, the 'Marshall-Lerner condition' observes that, if the sum of the demand and supply elasticities for a currency is less than one, an appreciation of the currency, which is assumed under normal conditions to cause a decline in net foreign exchange inflows, will not occur. In Cuba's case, because both CUP- and CUC-income households require a fixed amount of CUPs to make their basic purchases, the impact on net foreign exchange flows will be slight. Exchange rate appreciation would therefore cause little if any fall in demand for CUPs, and have only a relatively weak impact on supply. This condition will apply for as long as state subsidies keep the prices of basic CUP goods below the market level.

There is therefore little risk of any currency crisis sparked by Cuban peso revaluation. Indeed, because it is common knowledge that the Cuban peso is undervalued and that adjustment will eventually come, attempting to maintain the current rate is more likely to cause instability. In 2008, unfounded rumours that the government was about to devalue the CUC against the CUP from CUP24:CUC1 to CUP8:CUC1 resulted in massive sales of CUCs, and the 'clearing out' of stocks of CUPs held by the Cadeca exchange houses. As people consider that the moment of adjustment is coming closer, there is a risk of similar speculative incidents, and also of hoarding of Cuban pesos, which damages growth and adds to the difficulty of adjustment.

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Impact on competitiveness and dynamism

In the state sector, currency unification would not only improve competitiveness at a stroke by reducing the official value of the CUC, but it would also make meaningful enterprise autonomy possible, improving the responsiveness of enterprises to global market conditions and enabling the integration of the domestic and external economies. Autonomy would allow profitable companies engaged in exporting or import substitution to generate a surplus, and then use it to purchase more inputs and reinvest to expand capacity. Even companies operating entirely within the domestic economy would be able, for the first time, to source foreign inputs and weigh up the potential profitability of international expansion. Loss-making enterprises that failed to improve efficiency would face bankruptcy or takeover by more profitable competitors. The impact on overall productivity would be strongly positive.

Bankruptcy and redundancy, which are unfamiliar in Cuba, will become more common as the economy restructures. The government has drawn up new laws and procedures for the liquidation of companies, and is currently consulting on a new labour code, presumably in preparation for the changes ahead. Restructuring will inevitably sacrifice security in favour of dynamism.

In the non-state sector, the sudden appreciation of the Cuban peso would mean a reduced state subsidy. It would also remove many of the opportunities for generating profits simply by illegally diverting supplies from subsidised peso markets to sell in free markets. That is, entrepreneurial effort will be diverted from unproductive to productive activity.

The adjustment cost would be greatest for those operators whose business model had been most dependent on the exchange rate subsidy. Small businesses selling in CUC markets, in which the productivity per worker is only sufficient to pay CUC1 a day – which is enough for subsistence at the current exchange rate – would now need to generate around CUC20. Either earnings would need to rise, or the business would have to close. There would be upward pressure on prices in these markets, as wage costs rose, although these pressures would be mitigated by the forces of international competition. For example, a paladar (private restaurant) can only raise prices if its tourist customers would be willing to pay.

The only other way for non-state enterprises to restore real earnings would be to increase productivity. Exchange rate unification would immediately benefit efficient state enterprises, while the inefficient ones would lose their subsidies. In the non-state sector, enterprises that have been able to generate relatively easy profits because the existing Cadeca rate provides them with a hidden subsidy would be hardest hit. The longer the delay in making the adjustment, the more people will have become dependent on this unsustainable sector, and therefore the harder will be the social cost.

Impact on prices and incomes: winners and losers

There will be winners and losers from any change to the dual currency system. The impact of revaluation of the CUP relative to the CUC on prices will be mixed, with some prices rising and others falling. For example, fixed CUP prices would be unchanged, although their cost in CUC terms will increase because of the CUP's appreciation. Imported goods that are currently sold in CUCs would not change in CUC terms, but in CUP terms their prices will be lower than before. And in the free CUP markets, prices would tend to fall, to the extent that they are influenced by competition from imported goods. On the whole, if inflation is measured in CUP terms, the effect of CUP appreciation would be to reduce the price level.

"Rapid adjustment would, on balance, reduce the cost of living as measured in Cuban pesos. The impact on relative incomes would favour those earning CUP incomes, who would be better off in absolute and relative terms, finally starting to restore living standards and reversing the distortion that has favoured those with CUCs for the past two decades."

For CUP-income households, the impact would range from neutral to positive. For those with the lowest level of income, whose entire income is spent on basic goods at fixed prices, an exchange rate appreciation would have no effect on the cost of living, but for CUP-income households with income to spare, exchange rate appreciation would reduce the cost of living. That is, it would bring an immediate improvement in real income and living standards. The greatest percentage improvement in real incomes will be for those on higher CUP incomes. This will enhance the effectiveness of wage incentives.

For CUC households, exchange rate appreciation will result in a rise in the cost of living, that is, a fall in real incomes, as the prices of CUP purchases in CUC terms will rise by the amount of the appreciation. In effect, the revaluation will diminish the labour market distortion that has been caused by the undervaluation of the CUP. This will reduce income inequality, because Cuba's highest-income households are those with CUC incomes. However, households who have become dependent on jobs in the (informal or legal) non-state sectors that pay very low CUC-denominated-wages would suffer real hardship.

Rapid adjustment would, on balance, reduce the cost of living as measured in Cuban pesos. The impact on relative incomes would favour those earning CUP incomes, who would be better off in absolute and relative terms, finally starting to restore living standards and reversing the distortion that has favoured those with CUCs for the past two decades.

While this would generally have a positive effect on restoring work incentives, the adjustment would require provisions to protect those who have been earning very low CUC-denominated wages. The number of people in this category will continue to grow as long as the exchange rate adjustment is postponed, so the greater the delay in making the change, the larger will be the problem of poverty resulting from it. The restoration of a single set of prices will make it necessary, as well as possible, to establish a meaningful minimum wage for the non-state sector, in line with the minimum wage in the state sector.

6. REPLACING THE DUAL CURRENCY SYSTEM: WHAT ARE THE OPTIONS?

Unification of the CUP and the CUC, through the revaluation of the CUP and elimination of the CUC, is necessary to restore the functions of money in the Cuban economy, but not sufficient. The new currency will need to serve as a unit of account, store of value and measure of value not only within the domestic economy, but also for international trade. For this, it will need to be convertible, and if so, its value needs to both reflect supply and demand, and be sufficiently stable to earn the confidence of trade partners. What system would meet those requirements in the case of Cuba?

Alternative systems: float, fixed peg, sliding peg, managed peg

Free float

In theory, a new currency needs to be allowed to float freely in order to find its market level. However, this would be impractical for Cuba, where structural reforms are likely to lead to dislocations and in which financial markets are still very underdeveloped. Under these conditions, currency volatility would damage economic activity and trade.

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Adoption of a foreign currency

At the other extreme, absolute currency stability could be achieved by replacing the Cuban currency with a foreign currency. The adoption of a foreign currency is useful as a currency anchor when that currency dominates a country's international trade. Until now, the Convertible peso has been pegged to the US dollar (the natural choice given that Cuba's main traded products – sugar, nickel and oil – are denominated in US dollars in the international market), but adoption of that currency is ruled out by US sanctions. These not only prohibit Cuba from using US dollars for international trade, but also punish its trading partners if they engage in dollar transactions with Cuba. If the dollar is not a possibility, no other currency would seem to be a feasible candidate, as none of Cuba's other trading currencies account for more than half of its international transactions.

Sliding peg

Another alternative is a sliding peg against a foreign currency, which allows the authorities the ability to adjust the new currency for differences in inflation between Cuba and the country of the currency in question. However, determining what is, actually, the rate of inflation in Cuba would be challenging given that many prices are fixed by the government at levels that are way out of line with what would prevail in a market-based economy. A sliding peg that is based on a basket of currencies would have the additional challenge that Cuba's structure of trade, which has changed enormously over the past two decades, is likely to continue to do so in the coming years.

Fixed peg

By deduction, then, the logical solution appears to be a fixed currency peg, to anchor its value. The new currency could be pegged against the US dollar as the Hong Kong dollar has been since 1983. Alternatively, it could be pegged against the euro. Another option is the offshore traded Chinese renminbi (CNH), which is used extensively in Hong Kong.

Many of the best-known and successful currency pegs in the world today are used by governments of territories that are generally (if not always entirely correctly) seen as bastions of free enterprise. Hong Kong is a good example. Closer to Cuba geographically, so too are the Cayman Islands and Bermuda.

However, the mechanism is transferable to other types of economy. In the case of Singapore, a modified currency peg has been adopted by a one-party state, with a ruling People's Action Party (PAP) that has emphasised an independent national identity since independence in 1965, and intervenes heavily in the economy. There, the peg has contributed usefully to very strong economic performance with the gains very widely (if not totally evenly) spread across the population.

Steve Hanke and Kurt Schuler, two well-known academic proponents of the currency peg, advocated the mechanism's adoption by Cuba's government in 1992, arguing that this would be necessary to ensure that money serves as a medium of exchange, a store of value and as a meaningful unit of account.

They identified two aspects of currency pegs that would be important considerations for the Cuban authorities should they choose to peg the peso to another country. First, currency pegs need to be run by currency boards which are different in concept to central banks, in that they do not run monetary policy, act as lender of last resort, provide banking services to the government or (necessarily) act as institution of note issue. For Cuba, the creation of a currency board to administer a new revalued and convertible Cuban peso, pegged (in their case, they suggested that the peg should be to the US dollar) would be relatively straightforward. The Central Bank would carry out other central banking functions, but would not hold the foreign currency reserves that underpin the peso, or be able to expand or reduce credit in the economy.

The second essential aspect of a currency peg would be more of a challenge: the need for it to be credible. For this to happen, the currency board should be a strong and independent institution with a clear and narrow mandate and, above all, it must maintain sufficient reserve assets to buy back the local currency that it issues.

"The second essential aspect of a currency peg would be more of a challenge: the need for it to be credible."

(i) Creating a credible fixed peg: institutional requirements

Hanke and Schuler noted that one measure to boost the credibility of the currency board as a strong and independent institution might be the appointment of suitably qualified foreign nationals to its board. Their vision was of a currency board to be set up under the supervision of the US authorities in the wake of the collapse of the Cuban communism. The expectations of the early 1990s of the imminent collapse of the Cuban government have been shown to have been misplaced, leaving the question of whether or not it might be possible to create a credible, strong and independent currency board under the current system.

Even after Raúl Castro has left office (which will be no later than 2018), the Cuban government would be unlikely to countenance an intrusion into national affairs such as that proposed by Hanke and Schuler, but the authorities have demonstrated a willingness to accept technical assistance from foreign experts. It is therefore possible that the Central Bank, if it were to adopt a currency peg system, would allow foreign officials with experience of existing currency pegs (for example from the Hong Kong Monetary Authority, the Monetary Authority of Singapore and/or Banco Central do Brasil a central bank with long experience of exchange rate management) to play some role in providing advice and auditing of a currency board, if this was considered to be necessary to ensure its credibility.

(ii) Creating a credible fixed peg: reserve assets requirements

The greatest challenge for the Cuban currency board in terms of establishing a credible currency peg would be to obtain the reserve assets sufficient to match the money supply. The UN's Economic Commission for Latin America and the Caribbean (ECLAC) estimates that, at current prices, Cuba's GDP in 2011 amounted to US$68.2bn, and Mesa-Lago and Pérez-López (2013) note that monetary liquidity (M2) varied between 37% and 47% of GDP in 2005-11. Therefore if the authorities seek, in the first instance, to achieve a Cuban peso money supply of around 30% of GDP, they would need international reserves of around US$20bn.

It is impossible to know the current level of Cuba's foreign exchange reserves. The Cuban Central Bank does not publish any information on the level of reserves, on the grounds that they are national security-sensitive. For a few years, from 1993 to 2001, it published information on annual changes in their level, but since then even that information has been classified.

Balance of payments accounts provide some clues, but the rest is guesswork. The current account has been close to balance since 2001, with an average deficit of less than 1% of GDP. No figures have been provided for the capital account, but with major infrastructure and energy sector investments (financed from Venezuela, Brazil and China) having brought in substantial net new financing, it is likely that net capital inflows have been greater than the net current-account deficit, suggesting that the level of international reserves has probably been rising. On the basis of the available data, a very rough estimate of Cuba's foreign reserves would be around US$5bn. This would imply that the currency board would need to find an additional US$15bn or so.

To raise this amount, the currency board would need to persuade international creditors to purchase Cuban bonds. This would be challenging. For Cuba, US sanctions are the main problem here: they not only block access to US banks but also to multilateral financial institutions, and deter others. The currency board would have to seek the support of unorthodox creditors such as the governments of China, Russia, and Venezuela plus, possibly, the governments of Brazil, Ecuador and Angola. It could also offer the bonds to any private sector investors that do not have US interests that might be threatened. These might include, for example, mainland Chinese financial institutions with subsidiaries operating in Hong Kong.

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A further problem for Cuba is its poor debt history, with defaults in 1986 and again in the early 1990s, a breakdown in negotiations with Paris Club creditors in 2001, and a unilateral temporary suspension of repayments again in 2008-9 (following a devastating hurricane season). Mesa-Lago and Pérez López suggest that, in 2010, Cuba's total foreign debt could have been as high as US$72bn (including US$28bn owed to Russia, US$16bn to Venezuela and US$9bn to China), although other estimates suggest that the total (including 'inactive' debt that has not been serviced since 1986), is nearer US$25bn. Although the Cuban authorities are now prioritising debt repayments and the economic reform process appears to be steady and rational, potential investors would need much reassurance.

The currency board would need to persuade potential purchasers of its bonds of Cuba's potential for investment and growth that would arise from the stability and full convertibility of the new CUF. As argued above, the long term prospects for the Cuban economy would be improved by the unification of the exchange rate. Stable money would result in higher productivity and greater dynamism in both state enterprises and the non-state sector, enabling the government to repay outstanding debts and improving credit-worthiness. But with a poor track record and creditor unfamiliarity with Cuban conditions and prospects, it would be difficult to reassure creditors.

It might therefore be worth considering the possibilities for offering creditors some security against state assets. Individual Cuban state enterprises are accustomed to offering claims on future revenue streams as security, but a national bond issue would be a different question. There is a precedent, in the issuance of 400m of one-year bonds by the Central Bank in 2005-06, which were then listed on the London Stock Exchange in April 2006. The interest rate was 7%. The listing was designed to improve Cuba's access to international financial markets, but it was not new debt: it merely consolidated existing obligations to domestic state banks and foreign banks operating in Cuba. The issuance of bonds to raise new money on this scale would therefore be a new departure for Cuba.

If the Cuban government wished, it could also create a state holding company with ownership of a bundle of profit-making state enterprises – perhaps along the lines of Singapore's Temasek Holdings. The Cuban government could then give foreign holders of Cuban bonds long-dated warrants over a small share (perhaps 10-20%) of the new holding company. The warrants held by foreign investors would be detachable from the bonds and would be tradable. Given the likely involvement of Chinese investors and the success of the currency peg in Hong Kong, the Hong Kong Exchange (HKEx) might be one place for Cuban warrants to be listed, but it is not the only one. Changes in the value of the warrants over time would provide insights as to how developments within Cuba's economy are perceived in the wider world. The establishment of the CUF as a stable and convertible currency would of itself be consistent with a rise in the value of all state enterprises in Cuba.

Warrants over some of the shares in the new holding company could be allocated to Cuba's citizens. This should give them a sense of stakeholding. Further, the citizens' warrant holdings might be used as a foundation for a new social security (and/or social engineering) mechanism along the lines of Singapore's Central Provident Fund. However, this aspect of the Singaporean model would be unlikely to be of interest to the Cuban government, at least in the current stage of the reform process. At present, it sees no need to develop such a funding mechanism to persuade Cubans that they are stakeholders in the economy and reform process; this purpose is supposed to be fulfilled by the universal guarantee of basic needs and free health and education, the national consultation that set the guidelines for reform, and the on-going systems of participation and review that are a feature of the Cuban approach to restructuring.

"The move presents risks, but these may be less than the government fears, while the economic costs of inaction are not only huge but also growing. Currency unification is therefore increasingly urgent."

Conclusion

The elimination of currency dualism and adoption of a currency peg could provide the foundation for a new and exciting episode in Cuba's economic history in which investment, consumption and trade strengthen in a sustainable way. The move presents risks, but these may be less than the government fears, while the economic costs of inaction are not only huge but also growing. Currency unification is therefore increasingly urgent. Once unification is achieved, the monetary authorities will need to choose a mechanism for maintaining a stable but flexible exchange rate. Singapore provides an example of a country that has flourished thanks in part to a (modified) currency peg and in which the state plays a very important role within the economy, but its conditions differ in many important respects from Cuba's. The problems in raising sufficient international capital to support the peg highlight special difficulties faced by Cuba in its search for a place in the global market, arising from its history and ideology as well as US sanctions, but the ongoing restructuring of the domestic economy, and the diversification of trade and investment partners, are creating new requirements and possibilities for innovative solutions.

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