

Transition in Cuba: A Comprehensive Stabilization Proposal and Some Key Issues

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Introduction

The Cuban economy is currently undergoing a continuing severe contraction that is progressively weakening the socialist command system --a process dubbed *desmerengamiento*^[2] in Cuba-- and it is also increasing social unrest and political repression. This awful situation is forcing the communist party government to make necessary but insufficient policy changes and reforms reluctantly, in the vain hope of forestalling a change to a new government committed to clear respect for basic human rights and to transforming the economy to a market-based system within a democratic context. There is increasing political and social tension. Economic depression is turning political conflict into an increasingly serious social crisis. The communist party, like dictators Machado and Batista earlier in this century, has become more intransigent as momentum gathers against its rule and system.

While there is considerable debate about the degree to which the situation can continue to deteriorate in a country with Cuba's characteristics, exacerbation of human right violations and deepening critical shortages of food and medicines are of particular concern to those who fear it could lead to a plundering of national assets or selling and/or leasing natural resources at liquidation prices which could impede future economic recovery and development. This in turn is likely to generate a third massive emigration of Cubans to the U.S. following a change in government,^[3] as happened in the case of Albania or, in any event, that the further the situation is allowed to worsen, the greater the likelihood of a violent ending to the present regime.^[4] It is our firm conviction that while the socialist nature of the system is maintained, the economy will continue to disintegrate.

Ultimately it will be up to the Cuban people themselves to find a way out of this quagmire. This paper is based on the conviction that **the economic reforms necessary to reverse the declining standard of living of the Cuban people either requires or will induce fundamental political change.** This could come about as a result of a national dialogue leading to the establishment of a coalition government that would call for multi-party elections to be held within a reasonable period, which is our preferred solution, because it might facilitate a relatively peaceful process or, as indicated above, the end of the communist party regime could come about violently. In either case, actions taken and policies implemented during the first few months following a change in government are likely to determine the scope, pace and, therefore, the content and success of transition policies toward a market-based economy.

Many years of deprivation and human rights abuses, an unusually large quantity of weapons in the hands of the population, and the dire situation regarding basic needs and minimal sustenance means that Cuba will probably require a mediation (peacekeeping/peacemaking) and relief effort on the part of the international community to avoid/reduce bloodshed, bring about national reconciliation, stem the potential tide of emigrants to the United States, and help create the political conditions necessary to begin the stabilization process, followed by consolidation of the economic stabilization and an orderly transition to democracy and a competitive market-based economy.^[5] How can an appropriate international response be generated --quickly, to last a limited but realistic period of time, and with well-thought-out terms of reference that will facilitate implementation of a basic set of economic policies and reforms? What basic set of economic policies could/should be implemented during this "Emergency Period" to stabilize the economy and be consistent with short and medium term policies required to get Cuba back on its feet? What short-term policies are recommended to consolidate stabilization, initiate systemic reform and enable Cuba to rejoin effectively the international family of nations?

We begin with a summary presentation in Section I of the initial conditions that would be faced by any authority succeeding the current government in Cuba. Section II includes a brief discussion of some key issues that are of great concern to Cubans (those in Cuba as well as expatriates) as well as to the international community and therefore realistically cannot be avoided, will require immediate attention, and whose resolution will profoundly affect reconciliation, economic reconstruction and Cuba's reintegration into the international family of nations. Considerations relating to the terms of reference for an international mediation effort to assist in the process of reconciliation that will allow the implementation of economic policies are presented in Section III. The conceptual framework and basic strategy of the stabilization proposal is presented in Section IV. Section V contains the details of the proposal for stabilization, including policy options for the "Emergency Period" (called **Phase 1**) covering perhaps the first six months during which initial stabilization measures would be implemented, followed by a short to medium-term program (called **Phase 2**) to consolidate stabilization and begin the structural reforms required for transformation to a dynamic market-based system. Section VI concludes with some final observations.

The series of recommended policies covered may be grouped into three categories: (1) policies to begin and consolidate stabilization --fiscal, monetary, foreign trade and exchange, and prices; (2) policies designed to break the external bottlenecks --export promotion, negotiation of U.S. claims, debt renegotiation, capital remittances, and other external capital flows; and (3) policies to begin the process of structural, institutional and privatization reforms and the rationalization of the current social safety net to ensure social justice and to sustain the social achievements of the past 35 years.

I. Background: The Initial Conditions^[6]

"What brought down Communism in Russia? An antiCommunist party? A coup d'etat by the army? Invasion by a foreign force? No. Communism was brought down by Communists who could no longer separate their people with an Iron Curtain from images of other parts of the world that were moving forward as they stagnated under repression. The truth could no longer be hidden."

-- Shimon Peres, *Washington Times*, June 11, 1994

A. Historical Trends and Overview

In the 1974-1985 period, one of great turbulence in the world economy, Cuba was relatively isolated from two major oil price shocks and from the debt crisis that rocked the developing world. In spite of its inefficient economic system and artificial specialization in sugar, some growth and progress in the social sectors took place as a result of massive economic assistance from the Soviet bloc, foreign debt with Western countries and some liberalization measures in the late 1970's and early 1980's. However, these improvements came to an end in 1986^[7] when Cuba became the only communist regime that backed off from market mechanisms and material incentives for work, and they have reversed abruptly since 1989 with the cut-off of Soviet external transfers and preferential trade (see Table 1). The landing has been very hard.

In 1990 the Castro government enacted an austerity plan called "Special Period in Time of Peace," with people being moved to rural areas, as happened in Cambodia, to produce agricultural products for self-sufficiency. The main emphasis was on egalitarian distribution and transfers to those who have become unemployed. More recently it has adopted minor changes in policies without undertaking sufficient macroeconomic adjustment measures or institutional and liberalizing systemic reforms. The nature and specific design of its response has been ill-advised, late and plagued with inconsistencies because the essential features of the socialist system have been kept. At times there has even been a paralysis in economic policy. This has resulted in a costly and highly disorderly adjustment ("shock without therapy") with drastic declines in real income, increases in unemployment and acceleration of inflation in the black market.

There is a downward economic spiral. Production is plummeting and unemployment is mushrooming. Consequently, standards of living are falling substantially. This decline is the result of an abrupt encounter with the reality of the 1990's without massive external aid. It is the legacy of drastic allocative and structural errors and failures, together with a very inefficient system and the absence of a required adjustment for a better future in the context of a very competitive world economic environment (NAFTA and GATT). The broad scope of the crisis, which surpasses the purely economic sphere, affects every aspect of society. A climate of collapse and disintegration envelops Cuban society. The regime will not long survive at this level of mismanagement of the economy and of hardship. The government is increasingly facing challenges to maintain order and defend public property due to rampant frustration and widespread social and political disillusionment.

Table 1. Cuba: Main Economic Periods, 1975-1994

Period Main characteristics

- 1975- 1985 Progress under "limited market socialism:" In spite of a very inefficient system some progress was achieved based on massive assistance from the Soviet bloc and indebtedness with Western countries, together with liberalization measures adopted in 1979-1980.
- 1986- 1989 Stagnation under the return to Stalinist socialism: The very inefficient system became evident and began to show signs of exhaustion due to the counter-reform, repealing the liberalization reforms of the previous period and with excessive debt burden with Western countries.
- 1990- 1993 Deepening crisis under socialism: Steep decline in output due to the cut-off of massive Soviet bloc assistance. Reluctance on part of the authorities to adopt major stabilization policies and systemic reforms to stop a sharp decline in living standards.
- 1993- 1994 Continued deepening crisis and beginning of the disintegration of the socialist system under a late attempt at "limited market socialism." Continued decline has brought the economy to the verge of collapse due to ill-advised adjustment policies, insufficient reform measures and the strengthening of the U.S. embargo.

The socialist regime was successful in developing widespread coverage in education, health and social security based on the extraordinary external assistance by the socialist bloc. However, the economic foundation of this widespread social coverage is, indeed, weak as the economy's deterioration has accelerated since 1989, and especially since 1991 (see Table 2). Cuba is in the throes of a long-term systemic structural crisis and on the brink of economic disintegration.

By May 1994, the economic problems that have been building in the country since 1986 and that accelerated since August 1991^[8] have reached catastrophic proportions and have led to a progressive crumbling or *desmerengamiento*. The Cuban economy is currently in a severe depression and decay with substantial and ever-expanding imbalances: large excess demand at current prices and an increasing balance of payments constraint. Labor productivity has plummeted as employment has been artificially protected while production declined. Cuba is a rapidly undeveloping country, moving back into the Nineteenth instead of into the Twenty-first Century. These are the difficult conditions under which a new government will have to launch a stabilization program and initiate basic systemic reforms towards a market economy.

B. The Deepening Internal Crisis

GSP per capita has dropped more than 50 percent from 1989 to 1993,^[9] the deepest and most widespread depression in its republican history (see Table 2). This spiraling decline makes the depression of the 1930's look like a minor incident. Open unemployment and disguised unemployment or underemployment have reached record highs and are expanding. People are aware that their steadily declining standard of living is rapidly moving towards that of a subsistence economy and to the second-poorest in Latin-America. Effective real wages have declined as monetary wages have remained the same while goods obtained through ration allocations have declined substantially and those obtained in the black market have increased.^[10] Also, there has been a marked increase in prices on the black markets and at "dollar stores."^[11]

Fidel Castro has admitted that the country is undergoing the most difficult period of its history as a republic. However, he blames the U.S. embargo ("criminal blockade") and the deteriorating terms of trade for the misery that is much more the result of a system that penalizes individual initiative and is thus plagued with poor organization and very low productivity.

The overall public sector deficit has skyrocketed and is widening due to the erosion of external transfers, artificially low prices for the goods and services of state enterprises (69 percent showed deficits in 1993), and salary increases for the armed forces. Budget data available show persistent and escalating deficits, rising from about 2 percent of revenues in 1986 to 11 percent in 1989, 16 percent in 1990 and an estimated 34 percent in 1993.^[12] The social safety net expenditures increased from 17 percent of GSP in 1989 to 26 percent in 1992. A wasteful and substantial amount of spending continues to be channeled toward defense and internal security (more than 12 percent of GSP) which is an enormous drain on the economy.

There is a sizable monetary overhang, which is the legacy of monetized high and expanding fiscal deficits. Incomes are not declining as rapidly as production, and official prices have showed only minor increases. The almost frozen price level is much too low relative to the stock of money; the excessive monetary stock is 15 times the monthly wages and is expanding as a result of financing the fiscal deficits through monetary emission. The excess monetary assets are confronting limited real wealth and dwarfed productive capacity and naturally threaten the Cuban economy with hyper-inflationary pressures. This has led to excess demand with increasing shortages and spiraling black market prices in spite of widespread price controls and severe rationing of most goods and services.

Therefore, Cuba has a mix of "repressed inflation" in official markets and soaring prices in the black market. The symptoms of "repressed inflation" become more acute every day; although inflation is still restricted in official markets, there has been a dramatic burst of inflation in the black market because of the recent legalization of "dollarization"^[13] and the lifting of the ban on Cubans shopping in dollar stores, after prices were doubled. Ration allocations are slim to satisfy minimum consumer needs and are often not honored. People spend a significant amount of time in shopping queues, searching and bartering for food and other basic necessities, as well as feeling generally "hassled" and frustrated at not being able to obtain the most basic goods and services. There is widespread hunger and hardship. Most of the people are unable to look further than the next day. A sort of societal depression has set in, with the people unable to envisage a better future in Cuba. Consequently, there is a deterioration of labor discipline, motivation and morale, and increasing cynicism, pessimism, tension and even occasional demonstrations of social unrest.^[14]

As the economy disintegrates, social unrest spreads and political repression and violation of basic human rights increase. The daily struggle for survival is turning into a series of spontaneous actions seeking to overturn or escape the inefficient and corrupt system. The number of refugees making the perilous sea voyage aboard makeshift rafts from Cuba to Florida reached 3,656 in 1993 --its highest level since the massive Mariel boat-lift of 1980. Many of those fleeing Cuba now are young, blue-collar men who feel there is nothing left for them in Cuba: no work, no amenities, no freedom and no future in a very competitive world environment. The youth's expectations are colliding with the harsh daily reality and the endless demands for sacrifice, and the resulting disappointment has a way out: Miami.

Investment has been reduced drastically and there has been a significant deterioration of the capital stock. There is a clear inability to raise capital formation above a replacement level that would help to reverse the economic decline. Unfinished investment projects were three times the new investment in 1991.^[15] There is excess productive capacity (factories forced to close or work only a few days or hours per week) due to lack of raw materials and supplies, progressive deterioration of the industrial base, as well as major transportation problems for workers. There is a lack of domestic financial assets in which people can save. The transportation and communications infrastructure is in shambles and continues to deteriorate. Impoverishment and environmental degradation are spreading. There is a huge and widening housing shortage. The educational system is highly ideological, with an emphasis on marxist-leninist theory, designed to inculcate the commitment to failed egalitarian and communitarian ideals.

On the positive side, Cuba has a solid and broad human capital base. Literacy rates, schooling and the proportion of university-trained professionals are among the highest in Latin America (see Table 3). However, most of the university-trained professionals do not have the opportunity to practice their high skills and are becoming technologically obsolete due to the contraction of the economy. Nutritional, housing and basic sanitary conditions have been declining rapidly and have reached very low standards as living conditions continue to deteriorate, thus threatening what many consider to be the main areas of accomplishment of the communist party regime -- education, health care and social security.

C. The Widening External Imbalances

All Eastern European countries and the former Soviet Union have canceled their economic assistance programs and reduced their artificial trade with Cuba since 1989. Additionally the terms of trade are now less favorable to Cuba. Sugar and nickel are purchased at declining world market prices rather than at the heavily subsidized prices of the previous period.^[16] The shortage of hard currency, already serious before the present crisis, is now critical. Cuba is suffering a major external shock together with a tightening of the U.S. trade embargo as a consequence of the Cuban Democracy Act of 1992, which attempts to stop offshore subsidiaries of U.S. companies from doing business with Cuba and bars ships that dock in Cuba from entering U.S. ports for 180 days thereafter. The government has not shown the ability to

adapt to the increasingly competitive global environment. There are virtually no international reserves.

Table 2. Cuba: Selected Economic Indicators, 1971-1993

INDICATOR	1971-75	1976-80	1981-85	1986	1987	1988	1989	1990	1991	1992	1993	(average)	
% Annual Change Gross	7.5	3.4	7.2	1.2	-3.9	2.2	0.1	-3.1	-25.0	-14.0	-15.0		Social Product (GSP)
% Annual Change GSP	5.6	2.5	6.4	0.1	-4.8	1.1	-1.0	-4.0	-25.8	-14.8	-16.0		per capita
Exports, FOB (CUS)	2,004	4,463	5,980	5,322	5,402	5,518	5,400	4,410	3,585	2,300	2,100		million)
Imports, CIF (CUS)	1,990	3,870	6,331	7,596	7,584	7,579	8,100	6,415	3,690	2,500	1,700		million)
Sugar production	5,674	7,074	7,819	7,467	7,232	8,119	7,579	8,430	7,620	7,000	4,200		(thousand metric tons)
Budget deficit as	...	...	...	2	5	10	11	16	...	...	34		percentage of GSP
External debt in	...	...	...	4,985	5,657	6,606	...	...	6,800	7,600	7,800		convertible currency (CUS\$ million)

Sources: For 1971 to 1989: ECLA, *Economic Survey of Latin America*, various issues; and ECLA, *Statistical Yearbook for Latin America*, various issues.

1990-1993: The Economist Intelligence Unit, *1994 Report*, and authors' estimates based on news reports, official statements and articles published in Cuban journals.

Table 3. Cuba: Selected Social Indicators, 1986-1991

	INDICATOR
Crude mortality per 1,000 inhabitants (1989)	6.2
Population growth rate (1980-90)	1.0%
Population of retirement age and older (1990)	1,400,000
Population 65 and older (1990)	925,000
Infant mortality per 1,000 live births (1989)	11.7
Life expectancy (1989)	75.2
Physicians per 10,000 population (1990-91)	36.4
Hospital beds per 1,000 population (1989)	5.2
Adult Illiteracy (1990)	3.8%
Elementary School Enrollment-1990 (percent of 6-11 agegroup)	104.0%
Secondary School Enrollment-1990 (percent of 12-17 age group)	88.0%
Tertiary School Enrollment-1990 (percent of 20-24 age group)	23.0%
Expenditures in Armed Forces as % of GSP	11.3%
No. of armed forces as % of teachers (1987-1989)	124.0%
No. of armed forces per Physician (1987-1989)	8.0

Source: Carmelo Mesa-Lago, "The Social Safety Net in the two Cuban Transitions," in Florida International University, *Transition in Cuba: New Challenges for US Policy* (Miami, FL: FIU, 1993).

There has been a dramatic compression in imports. In 1992 import capacity was 28 percent of that in 1989 and in 1993 there was a further decline to 21 percent, [17] which is damaging to the population, since consumption levels have depended heavily on imported commodities. [18] Oil imports decreased from 13 million tons in 1989 to 7 million tons in 1992 and 5 million tons in 1993. The fuel crisis has taken a heavy toll on production, there are widespread and expanding power blackouts and low capacity utilization. Sugar exports will continue to shrink due to a shortage of spare parts, lack of adequate fertilization, breakdowns in the sugar transportation system, and lack of fuel for field operations and mill boilers.

Shrinking foreign exchange has squeezed both current production and capital formation, since domestic production of goods requires imported intermediate goods (oil, spare parts, raw materials, fertilizers), while foreign-made capital goods are an essential component in most investment projects, especially those necessary to generate new exports. Produce rots in the fields because there are few trucks available to move it to urban markets. The situation in key activities is characterized by a slump as a result of the external shock and the drastic failure of balance of payments and investment policies. Furthermore, key economic activities are facing a rundown of capital resulting from a cutoff of imports and the lack of market mechanisms.

The lack of sound money has its counterpart in the dollar gap that is due to a gross overvaluation of the Cuban peso. The official exchange rate is CUS\$1=US\$1, with CUS\$1.32=US\$1 for some tourism-related transactions, but as of May 1994, the black market exchange rate was CUS\$100=US\$1. Although holding dollars was illegal for Cuban citizens until July 1993, there has been a considerable dollarization as Cubans began accumulating dollars as a means of savings and to have indirect access to special shops that carry imported goods, because of the lack of consumer goods in government stores, loss of confidence in the peso, and increasing inflationary pressures in the black market.

Principal and interest arrears in servicing the substantial and unmanageable hard-currency foreign debt (approximately US\$9.4 billion as of April 1993) have made Cuba a pariah to commercial creditors, suppliers, and foreign governments. [19] In 1986, Cuba's creditors refused to roll over short-term loans and Cuba suspended interest payments. Cuba is now in default on most of its debt obligations. As of December 1993, the value of U.S. claims awarded by the U.S. Foreign Claims Settlement Commission (FCSC) was approximately US\$5.4 billion. Cuba is "off the books" for the main credit-rating agencies, meaning that no credit rating is currently being calculated. The country's risk premium (financial as well as political) is very high, which explains the extremely high rate of return and other conditions currently being offered to foreign investors (e.g., long-term concessions and tax holidays) that tend to discourage serious investors because they seem too good to be true.

The government is actively pursuing a policy of promoting and diversifying exportable products and markets to receive them. Therefore, it has been encouraging foreign private investment in joint ventures with Cuban state enterprises, seeking cooperative relations throughout Latin America and Spain. They also include a few with other Western European countries and Canada. However, Cuba's generally rigid, uncompetitive, and vulnerable economy, the absence of a State of Law (the legal system does not protect the investor from government abuse, and the judiciary system is not truly independent from government pressures), as well as the political and uncertainty risks about Cuba's future, cannot really provide an adequate framework for sufficient investment and trade opportunities. Hence, foreign investment has been far short of expectations. [20] Since Cuba will remain for the foreseeable future distinctly less attractive to foreign investment than most of its neighbors, it seems doomed to lag ever further behind the more dynamic societies of the Caribbean Basin.

D. The Systemic Institutional Sclerosis

Cuba is a Stalinist-style, totalitarian state, run by a rigid military dictatorship in which almost all power is concentrated at the top,^[21] with a collectivized economy and an extreme centralization of main economic decisions. The civil society is very poorly developed, providing almost no organized counterweight to the pervasive influence of the state. The country is run with an iron fist by a single party that refuses to submit to free elections with opposition parties. There is no tolerance of open (or public) dissent or even disagreement, because the leadership is extremely hostile to public criticism of its many drastic errors and failures. In a totalitarian system, it is risky for anyone to express openly his/her points of view, and those who disagree often suffer severe consequences. Although the regime attributed it to drug trafficking and embezzlement, it seems clear that General Arnaldo Ochoa was executed and several top officials imprisoned in 1989 because they were promoting "perestroika" for Cuba. Cuba is virtually closed to new ideas from throughout the world.

Although the experiment in socialism has been widely discredited, Cuba's government officials, with their vested interest in the status quo, have tried to preserve the fundamental features of the command socialist regime to retain party control over the economy and have exploited fears of the costs of the transition to a market economy without considering adequately its benefits. The message to ordinary Cubans is clear: the transition to capitalism is long and painful. They also argue that the economy might soon reach bottom and start to recover, and place virtually all the blame for the country's misfortunes on the US trade embargo, which provides an alibi for the domestic distress and helps reinforce the cohesion of the power structure. The lack of free markets and of private property have placed the economy in a straitjacket, but are considered by those in power to be the symbols of the success, stability, and continuity of the socialist model. Corruption, fraud and privilege among high-ranking public officials (the *nomenklatura*), that are inherent components of the socialist system, have been long-standing sources of popular discontent and widespread denunciation, which worsening scarcities --evidenced by a severe nutritional crisis-- have seriously aggravated.^[22] Enterprising members of the *nomenklatura* have been given excellent opportunities to enrich themselves.

The state controls most economic resources, allocates them through rigid and highly centralized planning, and has almost complete monopoly over foreign trade. Inefficiency in government is pervasive, and public sector employment in administration, military and internal security activities is unjustifiably high. There are extensive and comprehensive bureaucratic constraints and controls for state enterprises and the production and distribution of agricultural goods. The formal private sector is minuscule, with extensive and intensive public ownership of property in all productive sectors: only 8 percent of agricultural land is in private hands and there are few repair and personal services shops.

There are excessive, irrational, rigid and complex norms and regulations for every activity, lack of goods and factor markets, of legal market transactions, and an absence of such concepts as individual freedom and self-responsibility; therefore, the distortions to proper economic behavior are basic, substantial and widespread. Political credentials govern managerial promotions and appointments, producing widespread demoralization among younger professionals who are proud of their academic training and are forced to accept appointments that make a mockery of technical and professional standards. Abysmally inefficient economic structures and large monopolistic and oligopolistic state enterprises dominate production and the structure and organization of distribution. The structure of prices bear little relation to costs of production and to relative scarcities and opportunity costs, and the exchange rate is very distorted; they do not promote a good allocation and utilization of resources. Unions are political organizations whose major task is to ensure that party policies are implemented at the level of enterprises, with emphasis placed mainly on the need for rigid discipline at the workplace. The financial market is underdeveloped and passive, with the *Banco Nacional* (Central Bank) and its branch offices playing the role of rudimentary commercial banks and with very negative real interest rates.

E. Recent Policy Changes and Reforms

The continued and major decline of GSP since 1989 and the increasingly competitive world economy have forced the introduction in Cuba of some ground-breaking but cautious and modest elements of a market economy: joint ventures with previously banned foreign private investors; partial price adjustment in agricultural products, medicines, oil and public services; decentralization of some foreign trade operations; a few corporate businesses; legalization of possession of foreign exchange ("dollarization"); cooperativization of state farms; and limited steps toward private sector activity in the services sector with own-account work in 135 trades, crafts and services, from taxi drivers to hairdressers and computer programmers. Own-account private workers must receive official authorization and pay a presumptive income tax. In May 1994, some long overdue stabilization measures were announced to reduce existing internal and external imbalances.

These measures and reforms are incomplete in scope, imperfect in execution and inadequate in impact. They are still too little, and come too late to alleviate the overall crisis of the Cuban economy, and unless they are simply the first small measures that presage a vast transformation process, are unlikely to have much effect because most of the features of the command economy are still retained and impede the revitalization of the long-moribund economy.

The Communist Party --which is the sole party authorized, as provided in Article 5 of the Constitution of 1976-- thus far has not favored making major macroeconomic adjustments (in monetary, fiscal and exchange rate policies) or systemic institutional changes because it considers that they can erode its firm political control as happened in the former USSR and Eastern Europe. The price level, the official exchange rate and interest rates continue to be largely dissociated from the real money supply and the real value of domestic currency and capital. There are not enough and proper incentives to work and increase aggregate production.

The strict curbs on private enterprise are still in force are intended to prevent the emergence of autonomous internal economic power --to reduce and control the booming black market by legalizing and suffocating it, and merely to take in dollars rather than to unleash productive forces. The most successful privately-run restaurants and taxi activities are stridently curbed. Marked economic success, that is to say, any accumulation of riches is illicit. The improvements in incentives for agricultural enterprises, own-account workers and the legalization of dollarization are insufficient and have not been complemented by the development of sufficient instruments for reducing excess demand or stimulating aggregate supply to adjust to the new situation. For example, the authorities still do not allow the private commercialization of agricultural goods; nor own-account work by university-trained professionals or management personnel; nor the hiring of non-family workers or other types of contractual arrangements. Ultimately, the recent partial reforms are modifying incentives, but in a limited and sometimes in a perverse way, because they are increasing the macroeconomic imbalances and enhancing the duality and disintegration of the economy, making the system more macroeconomically unstable and socially explosive. The "hard heart" in this case also has the "soft head."

Two features of the recent reforms toward "market socialism" are bound to end in failure. First, the communist "reformers" do not really believe in competition and intermediation, so the new measures will not lead to well-functioning markets. Prices and wages remain controlled. International trade continues to be restricted so that the international market provides no real competition for domestic production. Entry by new firms into existing markets really does not exist; chronic shortages and excess demand means that new enterprises cannot get started or cannot survive because they cannot obtain necessary inputs, especially those of foreign origin. Second, the communist "reformers" have no interest in privatizing enterprises. They completely neglect or misjudge the enormous inefficiencies that come from lack of proper ownership of enterprises. They fail to realize that the "insiders" of the enterprises, managers and workers, could seriously distort enterprise behavior to their advantage. Perhaps, encouraged by the very low wages being paid, workers and managers extract "presents" from the firms and "bribes" outside the firms, stripping the enterprises of income and assets. The current system is an arrangement that inhibits work incentives and invites irresponsible economic behavior. It is impossible to fully integrate Cuba to very competitive world markets unless free competitive markets and private ownership are allowed.

Moreover, since indecision and reversals in basic economic policy-making have been a constant throughout the Castro period, this further diminished the credibility of recent changes, especially in view of Castro's strident anti-capitalism speeches at the special sessions of the National Assembly in late December 1993 (when no agreement was reached on further adjustment and reform measures) and in early May 1994 (when agreement was reached on further adjustment and reform measures), as well as on January 1, 1994 in celebrating his 35 years in power. When announcing most of the recent changes, he made clear that the moves were in direct response to Cuba's severe economic crisis; he also stressed his commitment to maintaining the essence of the socialist system, as had been evident in the changes made to the Constitution in 1992 and 1993. Hence, there is reasonable doubt about how long these measures will remain in effect.

The incompetent rigidity of economic policy and defiance of pragmatic measures mean that the socialist regime stands arrogantly and defiantly alone as an isolated and besieged anomaly and a vestige of the Cold War, with no feasible and comprehensive strategy to reverse the process of decline, with negative consequences concerning efficiency and productivity, thus compromising its own survival. "Socialism or Death" has an ominous ring; the end will come sooner rather than later. Cuba needs to

overcome deep and intrinsic severe institutional and systemic flaws and barriers to economic growth and requires more precise, broad, and coherent actions before stabilization, economic recovery and growth can begin in earnest.

F. Progressive Violation of Human and Labor Rights and Plundering of National Assets and Natural Resources

Due to the extremely difficult economic situation and due to its ineptitude and endemic corruption, the Cuban authorities are not forcing foreign investors to compete adequately for national assets and concessions, and they are getting extremely good and unwarranted deals. The communist "reformers" who have ruined the economy over the past 35-plus years are now about to encourage further plundering of enterprise assets and granting concessions over national assets and natural resources to foreigners at liquidation terms in a vain attempt to ensure the regime's long-term survival and for political acceptance and economic assistance. Furthermore, these foreign firms are engaged jointly with the Cuban authorities in violating basic labor rights of workers in particular, and the human rights of the population in general. This "final" economic solution has serious ethical and efficiency shortcomings. A hands-off approach by Cubans and the international community is not appropriate. It is neither morally acceptable nor economically desirable.

Anarchic foreign investment deals and concessions by which communist "reformers" grant part of the nation's wealth to foreign investors and appropriate the other part for themselves should be abrogated on fairness and efficiency grounds. On fairness and moral grounds, economic power should not be given to those responsible for creating the current chaotic economic situation and crushing democracy, nor to those foreign investors who by violating basic human and labor rights are able to reap unacceptable gains. On efficiency grounds, they are unjust deals that set a terrible precedent and discourage political support for needed impending privatizations and foreign investments. Of course, it is even less justifiable ethically to give sizeable proportion of ownership of assets and concessions of natural resources directly to foreigners who are violating basic human rights. Cuba is very likely to attract massive foreign investment from Cuban expatriates and U.S. investors in the future. Therefore, a future Cuban government should place heavy fines on foreign investors who have been violating basic rights and abrogate one-sided and unfair concessions.

II. Key Issues

A. The U.S. Embargo

It will be impossible to begin meaningful stabilization and recovery in Cuba unless the U.S. trade embargo is removed. Moreover, maintenance of the embargo will needlessly prolong the hardship suffered by the Cuban people, encourage further chaos and potential bloodshed, and will surely exacerbate attempts by Cubans to flee to the United States.^[23] However, there are two aspects of concern relevant to lifting of the embargo: one, originating in the Foreign Assistance Act of 1961 (Section 620a), is related to the expropriated property of U.S. citizens; the other is a political requirement of the Cuban Democracy Act of 1992 that infringes on Cuba's sovereignty and cannot be met until some time has transpired while reconciliation and peacekeeping efforts are underway.

The Cuban Democracy Act of 1992 is an extremely controversial piece of legislation that violates principles of international law. Our purpose is to address only those aspects of this law that would affect policies undertaken during the Emergency Period. The sanctions specified include: a prohibition on "certain transactions between certain U.S. firms and Cuba," meaning specifically subsidiaries of U.S. firms in other countries; prohibitions on vessels engaging in trade with Cuba, or carrying goods or passengers to or from Cuba, from loading or unloading, or entering, a United States port; and limits on remittances to Cuba. According to Section 1708 of this law, the President of the United States may waive the sanctions upon determination that the government of Cuba --

"(1) *has held free and fair elections* conducted under internationally recognized observers;

(2) *has permitted opposition parties ample time to organize and campaign* for such elections, and has permitted full access to the media to all candidates in the elections;

(3) is showing respect for the basic civil liberties and human rights of the citizens of Cuba;

(4) is moving toward establishing a free market economic system; and

(5) has committed itself to constitutional change that would ensure regular free and fair elections that meet the requirements of paragraph (2)."^[24] (Italics ours)

Without disputing these goals, as a matter of principle, we feel compelled to state our conviction that these conditions infringe upon Cuba's independence, much as the Platt Amendment limited Cuba's independence in 1902 and bred hostility between the U.S. and Cuba. However, more to the point of this paper, since complying with points (1) and (2) above will inevitably take longer than six months, the Cuban Democracy Act will constitute a significant obstacle to reconciliation and starting the process of stabilization. There seems to be no logical justification for the United States to prolong a policy of economic warfare against Cuba by continuing it into the Emergency Period following a *fundamental* change in government.^[25] Our understanding is that repeal of the Cuban Democracy Act would not terminate the embargo.

Obviously, for Cuba to shake off the disastrous effects of the past 35-plus years, it will be necessary for it to develop friendly relations with the United States. Similarly, it will be in the U.S.'s national interest to assist in creating the conditions under which the Cuban people may peacefully rebuild their shattered country, thus lessening the pressure for people to migrate *massively* to the United States as well as an eventual need for even larger amounts of financial assistance.

We concur fully with the Inter-American Dialogue's Task Force on Cuba that "*the goal of policy should be to make possible a Cuba that remains sovereign, that is free from violence, that ends repression and fosters democracy, and that regains its economic health.*"^[26] However, an important caveat is that the concept of sovereignty is based on the *sovereign will of the people* to freely choose their system of government and their governmental officials; it does not mean the sovereignty of the Communist Party.

As humanitarian act the United States should immediately and unconditionally lift the embargo on trade of food, medicines and medical instruments. Also, **the United States should lift all aspects of the embargo immediately upon a fundamental change of government in Cuba**, trusting that a policy of constructive and compassionate engagement, at the very outset, with a National Reconciliation Council or provisional government committed to respecting human rights and to the holding of free multi-party general elections, and then with an eventual democratic government of Cuba, will result in an acceptable resolution of issues pending between the two countries.^[27]

B. Claims Against the State

While one might argue that consideration of claims against the government of Cuba should not be addressed during an initial Emergency Period, three elements have combined to make this a major issue even prior to a change of government: (a) policy statements by the U.S. government indicating that the trade embargo on Cuba will not be lifted until there has been satisfactory resolution of claims on the part of U.S. citizens;^[28] (b) statements and activities by Cuban expatriates and U.S. claim-holders ranging from demands for restitution of lost properties to full compensation; and (c) use of these statements or activities by the Castro government to encourage fear of mass evictions or relegation to second-class status that would result from a change in government. In addition, future external financing from multilateral financial agencies will be blocked by the U.S. pending resolution of claims.^[29] Clearly policy regarding claims against the state constitutes a key issue for achieving a meaningful national reconciliation, without which it will not be possible to terminate the Emergency Period, reduce the possibility of bloodshed and get on with the task of rebuilding a shattered economy.

Economic stabilization, law and order, food, medicines, the establishment of workable institutions for policy implementation, and establishment of property rights are critical to Cuba's reconstruction and without doubt will have to be addressed immediately. Privatization has proceeded at a disappointingly slow pace in some Eastern Europe countries, in part due to delays in resolving the property rights issue. Travieso-Díaz has pointed out that based on the widely differing experiences in Czechoslovakia, Hungary and Poland,

"whatever process is followed . . . must provide an unequivocal adjudication of property rights so that no legal obstacles to the privatization of enterprises are interposed by the existence of unresolved property claims against them."[\[30\]](#)

Therefore, while there is general agreement on the need to privatize state-owned enterprises and attract foreign investment to Cuba as rapidly as possible, there must first be a determination regarding the issue of property rights. Moreover, unless clear and transparent "rules of the game" are set and implemented, the amount and quality of investment taking place will be less than what is needed to put Cuba on a sustainable and high growth rate.

1. General Considerations

We take the position that claims against the Cuban state should not be limited to property claims, but should include all manner of torts --involuntary or uncompensated work, unjust imprisonment, loss of life or limb, loss of loved ones, physical or psychological abuse and harassment by agents of the state, discontinuance of pension payments, etc.[\[31\]](#) --whose aggregate cost defies imagination.[\[32\]](#) Indeed, we doubt there is any legal or moral basis for assigning priority to settling claims against physical property over those claiming civil damages such as those suggested above. Moreover, precedents of various forms of compensation in ex-Socialist states such as East Germany, Czechoslovakia, Romania, and Hungary notwithstanding, the magnitude of the disaster in Cuba and the requirements to set the country back on track socially, politically and economically leads one to conclude that attempting to set up a process of claims adjudication in Cuba, at least during what will no doubt be an extremely difficult transition period, would be pure folly.

Interestingly, according to Section 503(b) of Title V of the International Claims Settlement Act of 1949,[\[33\]](#) claims of U.S. nationals were allowed "for disability or death resulting from actions taken by or under the authority of the government of Cuba..." In at least one case, that of Jenny M. Fuller, et. al. (Decision CU-6199), the Foreign Claims Settlement Commission of the U.S. (FCSC) made an award based on what it considered to be wrongful death, because it felt that Cuban authorities had discriminated against two U.S. citizens in executing them although they had admitted guilt to armed uprising. Loss of pension benefits were also allowed by the FCSC.

One essential question to be answered is whether attempting to arrange some form of non-cash compensation for property and tort claims will be more conducive to reconciliation than adopting a no-compensation policy. For example, in Romania it was felt that like many of its citizens, the country was suffering from post-traumatic stress syndrome, for which it had to undergo a difficult process of critical self-examination, healing, and reconstruction. Under a victim compensation law, more than 100,000 Romanians have claimed compensation which, aside from cash, has been granted in the form of benefits such as free public transportation and preservation of job seniority.[\[34\]](#)

2. U.S. Claims

The *casus belli* for the U.S. embargo on Cuba was the nationalization or confiscation of property owned by U.S. citizens and corporations in 1960. Following enactment by Congress of the Cuban Claims Act of 1964, the FCSC adjudicated close to 9,000 claims by U.S. citizens and firms, and certified awards in 5,911 cases totalling approximately \$1.8 billion, of which \$1.6 billion were corporate claims (see Table 4). The FCSC ruled that *simple* interest of 6 percent per annum should be charged from the date of the actual loss to the date of settlement, bringing the total value of U.S. claims to approximately US\$5.4 billion at the end of 1993.[\[35\]](#)

The government of Cuba from time to time has floated suggestions that it would be willing to negotiate the compensation issue, although this may have been mainly a ploy to undermine support for the embargo. While the Cuban Democracy Act would appear to shift the conditionality for lifting the embargo to the holding of free elections and makes no mention of U.S. claims, the queue of claimants has been in existence for many years and is increasingly active and organized given the prospect of the demise of the communist party regime. Obviously, lifting the embargo is a necessary though not sufficient condition for Cuba to have the ability to service its obligations. Therefore, as a result of the combination of the Foreign Assistance Act of 1961 and the Cuban Democracy Act, **only a transition government of Cuba, committed to holding free and fair elections, will be able to negotiate the issue of U.S. claims with the government of the United States in order to resolve this matter.**

Since the lifting of the U.S. embargo is a priority, Cuba must indicate its agreement to enter into formal bilateral (government-to-government) good-faith negotiations regarding U.S. claims, *but that the embargo must be lifted prior to concluding the negotiations*. Some have indicated disingenuously that lifting the embargo prior to settling all claims would "compromise the entire U.S. Cuba claims issue" and that the United States "would lose any leverage it may otherwise have had with regard to the prompt resolution of the U.S. Cuba claims matter."[\[36\]](#) This argument is patently absurd, since Cuba's development hopes are inextricably tied to its relations with the United States. The challenge for both the U.S. and Cuba will be to build a relationship based on mutual respect and trust.

The government-to-government negotiations aspect is also important. One could reasonably argue that in filing claims before the FCSC, U.S. citizens and corporations in fact requested the U.S. government to demand compensation, and the U.S. government did so by placing and maintaining an embargo on trade with Cuba. Furthermore, the U.S. government paid at least partial compensation to claimants through the tax system. In fact, the Internal Revenue Service implemented a program allowing individual and corporate *taxpayers* (i.e., including Cuban expatriates who were taxpayers and suffered losses) to take federal income tax deductions for losses of property confiscated by the Government of Cuba. This, however, is a double-edged sword in that the FCSC allowed losses by U.S. *citizens*, whereas the IRS program benefitted *taxpayers*, whether or not they were citizens; it is therefore probable that the tax revenues foregone by the U.S. government could significantly exceed the amount awarded by the FCSC.

Therefore, all U.S. claimants (citizen and non-citizen taxpayers) made their claims subject to international negotiation and, under the doctrine of espousal, must abide by the settlement made by the U.S. government. Rather than negotiating with each claimant, Cuba should indicate its readiness to negotiate this matter bilaterally with the U.S. government.

3. Restitution

Various arguments have been advanced in favor of the return of confiscated property to the former owners.[\[37\]](#) These arguments fall into the following categories:

- * Property rights were protected against confiscation by the Cuban Constitution of 1940; they should therefore be returned.
- * Since the government of Cuba does not have (and will not soon have) the means to compensate promptly, adequately and fairly, restitution is the best (only) workable alternative.
- * Restitution is the best way to implement rapid privatization and encourage recapitalization of the economy.
- * In the case of corporate claims, former owners have the managerial talent necessary for rapid development of the enterprise.
- * Other formerly socialist countries (Eastern Europe, Nicaragua) have implemented restitution policies.

Table 4. U.S. Corporate Claims Against Cuba:

Awards Exceeding US\$20 Million at Time of Loss

Corporate Claimant	Decision	Award, US\$million
Cuban Electric Company	CU-4122	267.6

ITT, ITT as Trustee	CU-5013	130.7
North American Sugar Industries	CU-3578	109.0
Moa Bay Mining Company	CU-6049	88.3
United Fruit Sugar Company	CU-3824	85.1
West Indies Sugar Company	CU-5969	84.9
American Sugar Company	CU-3969	81.0
Standard Oil Company	CU-3838	71.6
Bangor Punta Corporation Baraqua Industrial Corporation Florida Industrial Corp. of NY Macareno Industrial Corp. of NY	CU-6034	53.4
Francisco Sugar Company	CU-6066	52.6
Texaco, Inc.	CU-4546	50.1
Manatí Sugar Company	CU-6020	48.6
Nicaro Nickel Company	CU-6247	33.0
Coca-Cola Company	CU-6818	27.5
Lone Star Cement Company	CU-6217	24.9
New Tuinucú Sugar Company, Inc.	CU-6817	23.3
Other Corporate Claimants (approx. 882)	335.2	
Individual and Other Claimants (5,013)	221.0	
Total Amount Awarded	1,799.5	

Source: United States Foreign Claims Settlement Commission, 1972.

Fortunately, most Cuban expatriate groups have recognized that restitution of dwellings or residential property is not advisable. The discussion can then be restricted to non-residential property.

Accepting the possibility of restitution in resolving claims also means accepting legal encumbrance on property. Lawyers representing claimants are being disingenuous in arguing that restitution could be accomplished quickly.^[38] Ruling out restitution simply means that any litigation would be limited to challenges concerning the validity and quantification of the value of losses, and the compensation, if any. By ruling out restitution, a future government of Cuba could proceed immediately to privatize all small and medium-size businesses, corporatize large enterprises and take steps to improve their financial footing prior to privatization.

With respect to U.S. claims, in the first place, there is an assumption that simply because the FCSC established a procedure and adjudicated claims, these claims are automatically valid and there is no need to reopen the cases; therefore, restitution could be accomplished quickly. However, our examination of several claims leads us to conclude that *many awards made by the FCSC are open to question*, and thus validating even those claims could easily take several years, during which there would be a strong disincentive to invest.^[39] For example, in the award of US\$27.5 million made to the Coca-Cola Company, US\$6.1 million was for an inventory of 1.5 million cases of soft drinks each valued at US\$4.01 *without evidence to sustain the claim*; 40 another US\$8.2 million was the "going business value" which was added to the actual losses sustained by the company. (If claims awarded were inflated to a value of twice the actual loss, as in this case, at a marginal tax rate of 52 percent, the tax benefit would roughly compensate entirely for the loss.) Since the FCSC denied a number of claims and it can also be assumed that not all U.S. claims were filed, the entire process would have to be reopened.

Secondly, if we were to take only the fifteen largest U.S. claims (totalling US\$1.2 billion, which is equivalent to 67% of total U.S. claims), we would find that U.S. nationals owned:

- * 90% of all electricity generated on the island (Cuban Electric Co.)
- * The entire telephone system (ITT)
- * Most of the mining industry (Moa Bay Mining Co. & Nicaro Nickel Co.)
- * Significant tracts of some of the best land in Cuba (between 1.5 and 2 million acres)^[41]

Returning these properties, *ipso facto*, to U.S. ownership, even if it were feasible to do so, would be tantamount to insisting that nationalistic feelings in Cuba due to foreign ownership of the country's principal assets never had a basis in fact. Moreover, it would tend to lock the country back into a sugar-dominated structure of production, precisely at a time when an unintended benefit of Cuba's economic collapse is having the opportunity to diversify away from a declining industry (see Section II.F below). In the case of public utilities, the value of a concession to provide electric power or telephone service to a country of 11 million is significantly greater than for a country of 6.5 million, which Cuba was in 1959. We consider that Cuba must have a very competitive and dynamic economy and such monopolistic concessions would be totally incompatible with this objective.

The issue of modifications to property making restitution impractical is not trivial.^[42] As a result of modifications, some former owners would receive nothing while others could receive more than they lost. In the case of small business owners (there were 855 corporate awards totalling US\$123.3 million), the likelihood of physical disappearance and/or substantial modification is extremely high.

4. Compensation

As pointed out above, to be fair any consideration of compensation for property loss in Cuba must be matched by arrangements to compensate for tort claims.

While conceding that great damage has been done to many by the communist party regime (and probably more to those living in Cuba than abroad), we take the position that the cost in disruption from trying to adjudicate tort and property claims --let alone finance them-- would greatly exceed the benefits, and that sound, stable and transparent policies, together with a safety net, ultimately will be the best way to turn the country around and avoid a long-term legal confrontation with a resulting investment paralysis. Therefore, regrettably, for the reasons indicated above, **no claims against the State for confiscations or damages to persons or property should be considered**. No damages should be paid for loss of life or limb, unjust incarceration, etc.; properties confiscated should not be returned to their former owners nor should the State pay compensation for those losses.^[43] In order to implement this policy and minimize the likelihood of future challenges, a constitutional provision or amendment should be adopted to the effect that no government tort or property claims resulting from actions occurring between January 1, 1959 and a date to be specified prior to assumption of power by a new governmental authority will be considered.

However, an important issue to be considered is the negative impact a no-compensation policy might have on the government's credibility in reestablishing private property rights. It is also felt that future investment will be discouraged unless there is some form of official recognition of past losses, for which special consideration might be given during the process of privatization. In Section II.C below, we suggest the corporatization of certain large military bases in Cuba and their conversion to

free trade zones, with labor being provided by the deactivated military. In a NAFTA world, free trade zones may be less attractive possibilities. Nevertheless, as an example of one possible alternative to a no-compensation policy, a compensation scheme might be built into the corporatization of military bases. In this regard, a future government of Cuba might negotiate the termination of U.S. rights to Guantánamo Bay, an obsolete naval base of 117 Km², which occupies one of the three best Cuban ports, corporatize all or part of the area, and use a share of the income from the sale of shares, leases or profits from that property to compensate the government of the United States for U.S. claims. We also suggest that consideration be given to making a good-faith gesture by way of a pro-forma compensation using Cuban government assets currently frozen by the United States (US\$65 million in 1961).

Obviously, there is no reasonable way for a future government of Cuba to justify compensating the U.S. and not its own citizens. Compensation of Cuban and other claimants who did not receive tax benefits from the U.S. could take the form of issuance of shares or discount coupons to be used to purchase shares in selected corporations.

C. The Armed Forces and Internal Security

1. Demilitarization and disarmament

Being a small island nation, Cuba has no national security need for armed forces beyond a coast guard and limited security forces sufficient to police the country and protect against it being used as a drug trafficking station or for any other criminal endeavors.^[44] Moreover, the program for stabilization and structural reform presented in Section IV below is based on a significant reduction of the public sector deficit, which in turn depends on a significant reduction of military and internal security expenditures. Therefore, **demilitarization/disarmament** is a crucial element of the program for the economic reconstruction of Cuba.

The current huge size and particular structure of the armed forces in Cuba will present a considerable challenge to the implementation of a policy of demilitarization and disarmament. While a specific plan to implement this policy is beyond the scope of this paper, the impact of demilitarization on the labor force and the economic value of military assets makes it appropriate to make some general suggestions.

Initially, the armed forces could help in disarming all internal security and paramilitary groups, such as the militias and the "rapid response battalions." Another possibility that may have favorable future effects is to offer several battalion-size units (equivalent to approximately 1,000 men each) of the Cuban army to the United Nations for service in peacekeeping operations in other countries, thereby receiving practical training in reconciliation; these battalions could at a future date become Cuba's small security force other than police.

Most of the armed forces matériel should be auctioned off as rapidly as possible in order to maximize the value that might be obtained and to minimize maintenance costs, while retaining only the minimum necessary for a small rapid-deployment force, together with the equipment that may be readily and efficiently converted to civilian use.

2. Construction/rehabilitation battalions

During the Emergency Period (Phase 1, See Section IV.C.), and taking advantage of their organization and command structure, most of the armed forces should be turned into construction battalions and assigned duties related to rehabilitation of roads, water and sewerage, ports, tourism facilities and other infrastructure, or to the construction of sites and services for the population, following a master plan and within financial constraints consistent with the policy of significant reduction of the public sector deficit outlined below in Section V.A.^[45]

3. Conversion of military bases to industrial parks or free trade zones

There are several military bases throughout the island --in Mariel, Matanzas and Nicaro on the Northern coast, and Cienfuegos, Guantánamo, and Santiago de Cuba on the Southern coast-- that are well-equipped in terms of all manner of infrastructure, including water, electric power, hangars and warehouses, access roads, proximity to airport and/or port facilities, transportation and cargo equipment, etc. Rapid conversion of the principal bases into industrial parks or free trade zones should be studied, including the design of special incentives for investors to use ex-armed forces personnel to provide temporary labor required for conversion as well as retraining for more permanent jobs in the new plants that locate there. In establishing free trade zones, bonded factories and warehouses should be allowed to import machinery, equipment, and manufacturing components duty-free, provided that all imported inputs are reshipped abroad (see Section V.E).

D. Pensions and the Elderly

As we have seen in the case of Eastern European countries making the transition to market-based economies, as well as in countries that have recently undergone structural adjustment, those most vulnerable are the elderly and the disabled who have no source of income other than state-financed pensions, and those approaching retirement age and are not able to accumulate sufficient wealth to finance their retirement. Cuba is no different, and the fear of change that grips these groups must be addressed at the outset, for they constitute an important barrier to economic reform and possibly to national reconciliation in a democratic environment. Moreover, apart from considerations of social responsibility, the state has a contractual obligation to those who labored for it during the past 30-plus years and who have suffered the most from the socialist system.

1. Retirees (men age 60 and over and women age 55 and over) and pre-retirement workers (age 50 to 60)

Cuba had 1,172,000 retirees in August 1992. Population projections place Cuba's population aged 60 years of age and older at approximately 1.3 million persons between 1990 and 1995 --about 12 percent of the population-- and until recently the country had one of the highest life expectancies in the world. Virtually all these persons depend completely on government pensions for which it may be presumed they contributed, and being past working age, they cannot be expected to make any further contributions at all. **Government current expenditures therefore must continue to fully fund sustenance to this entire group of elderly Cubans.**

A second group consists of persons who are within ten years of retirement, for whom it is too late to generate a new self-financed pension system, although they are still able to contribute financing towards their pensions. **The government-financed pension system for retirees should be extended also to workers aged 50 and above,** and require that each make a corresponding contribution during his/her remaining work life.

The budgetary calculation to provide pension payments to all members of this group may be based on an actuarial assumption to the year 2010.

2. Other workers (less than 50 years of age) and new entrants

A self-financed private pension system should be established for all those below 50 years of age and new entrants to the labor force, under general government regulations to ensure and protect adequate reserves (see Section V.D below).

According to official figures, life expectancy in Cuba is one of the highest in the world; therefore, **the retirement age should be raised to 65 years for both men and women.**

E. Education, Health, and Social Security

The people of Cuba consider the public health (in recent years 12 percent of the public budget), the education (24 percent of the public budget), and the social security systems to be the primary achievements of the revolution --benefits that, in contrast to rationed or unavailable goods, have been extended universally-- which they very

much wish to preserve. Indeed, along with a strong fear that mass unemployment will result from a change in government and transformation to a market-based economy, Cubans fear they will lose the education, health, and social security benefits they have had for many years.

An educated and healthy population is one of Cuba's principal assets, one that must be preserved and maintained. Therefore, a cornerstone of this reconstruction package is to continue offering **free high-quality public primary and secondary education and guaranteed health care for all Cubans**.^[46] However, it is important to study and design adjustments to: (a) rationalize costs in education, especially higher education; (b) introduce cost recovery mechanisms to the health care system and target public funding on the disadvantaged; (c) encourage the private sector to offer education and health care services; (d) decentralize the administration of primary and secondary education and basic health care facilities to the municipalities, while retaining policy-making in areas such as curricula, standards and performance measurement at the central government level; and (e) encourage the establishment of vocational training and other non-formal education facilities to prepare workers for market-based activities.

F. Sugar Industry Reconversion

1. Cuba's increasing specialization in sugar

Sugar has long been the foundation of the Cuban economy. For decades prior to the 1959 revolution, sugar provided around 80 percent of export earnings and was so pervasive that a popular phrase was "without sugar there is no country" ("sin azúcar no hay país"). Prior to 1960, the United States bought nearly 3 million tons per year, over 50 percent of Cuba's sugar exports, to accommodate about one-third of U.S. domestic consumption. As pointed out in 1956 by the *Banco Nacional*, by the 1950's sugar ceased to be a source of economic growth and lacked the capacity to sustain economic development. Sugar output during the 1950's barely surpassed that of the 1920's.

Cuba's overwhelming dependence on the sugar industry and on extensive planting was seen by the young revolutionary leaders as a signal of underdevelopment; the slogan was "because of sugar there is no country" ("por el azúcar no hay país"). Nonetheless, the strategy of sugar-led development was reaffirmed in 1964, after a drastic failure in the agricultural diversification and industrialization programs. Therefore, the Cuban economy today still depends heavily on sugar, and the communist party regime still gives priority to the sugar industry with very few changes having been made in the structure of production. Such dependence on a single product obviously placed the Cuban economy in an extremely vulnerable position.

For the period 1963-1989, relations between Cuba and the former Soviet bloc grew ever closer as the Cuban economy was integrated into that bloc. Cuba has followed the edicts of the marxist division-of-labor theory to do more of what it did best in the capitalist epoch: grow sugar. The communist party regime aggressively expanded sugar production during the 1960's and 1970's, crowning the strategy with the irrational "long harvest" (217 days) in 1970, during which the authorities focused all the island's physical and human resources on trying to produce a 10-million-ton sugar crop. This policy was opposed by a number of technicians and administrators in the sugar industry, but they were overruled.

Cuba's specialization in sugar was based on artificially stable and high prices for raw sugar and subsidized inputs, engendering a false sense of security and discouraging economic diversification. The artificial price structure led to the wrong mix of production and distorted organization of production. The industry is old-fashioned, the workers do not have the proper skills and the production units are dilapidated. Consequently, there have been declines in productivity in terms both of tons of cane per hectare and the sugar content per ton of cane. Meanwhile, the U.S. and Western Europe protected their domestic markets and moved away from sugar cane and toward high fructose corn syrup, saccharin and aspartame.

2. Current difficulties of an industry in decline

The real prices of sugar of the 1990's are similar to those of the decade of the 1930's, that is to say the lowest prices of Twentieth Century. Cuba has not modernized its sugar industry technologically despite heavy but misdirected, capital investments made over the 1970's and 1980's to expand and renovate its production capacity, because increased productivity and technological expertise were not goals in and of themselves. Furthermore, Cuba's anachronistic milling sector continues to have a significant number of small, inefficient and polluting units. Two-thirds of the mills have daily grinding capacities of 5,000 tons or less and 85 percent were built before 1913. Many if not most of them will have to be shut down and others will need to shed labor on large scale. The switch from manual labor to machines, particularly for harvesting, was the most significant development in Cuba's sugar cane agriculture over the 1970's and 1980's. In the late 1980's, 100 percent of land preparation and about 90 percent of the cultivation and fertilization were done mechanically. Cane cutters ("macheteros") cut cane only in areas too rocky or steep for combines, their numbers dropping from 350,000 in the 1971 crop to 56,000 for the 1991 harvest. In a labor-surplus and an import-scarce economy, the main export activity became increasingly a capital-intensive and an import-intensive one.

The chronic shortage of oil and spare parts, as well as inadequate repairs and maintenance, have reduced the use and efficiency of harvesters. Mills frequently are not supplied with enough cane and many machine hours are lost. Cannibalization and lack of spare parts have led to the shutting down of many sugar mills. This typically extends harvesting and milling into the rainy season. These problems were evident when Castro blamed a chronic shortage of fuel, spare parts, and lubricants as well as early-season rains for a marked decline in production. Cuba reported a 4.3 million-ton crop in 1993, the lowest in 30 years and some observers predict an even smaller crop in 1994 (4.0 million-ton crop). According to official estimates, the state provided subsidies to the sugar industry totalling CU\$7.2 billion in 1990-1993.

3. Cuba has a promising future in a restructured economy

After spending 30-plus years specializing Cuba's economy in sugar and integrating it with that of the Soviet Union and its socialist allies, the Cuban government now faces a vastly changed world, realistic prices and an internal order with inefficiencies in the sugar sector. On one hand, Cuba is facing shrinking and highly competitive export markets, especially for raw sugar and, on the other, sugar production will continue to drop unless substantial investment is made to modernize the industry. The general picture is one of painful and costly reconversion. Cuba lacks the refining capability to export large volumes of refined sugar needed to expand markets in North Africa and the Middle East. The prospect of substantial investment in sugar production and refining capacity through joint ventures with foreign companies may indicate the direction of the industry, but this is a very risky business due to market outlook and political considerations. Sugar uses seasonal labor and the most fertile land, currently some two-thirds of all the cultivated land in Cuba.

All signs point toward a further downsizing of the sugar industry to make the country and the industry economically viable in a competitive market economy environment, moving resources away from sugar and toward domestic and export food production, which appears to hold significant potential. However, any major decision requires an important and clear national definition regarding property rights and claims. It seems that, ironically, only the communist party regime and some expatriate former owners of sugar mills and landowners want Cuba to remain specialized in sugar, determining a grim and hopeless economic future. In our opinion, Cuba can either specialize in sugar or be prosperous, but not both. It is time to face the painful but necessary task of disengaging from the dependency on the sugar industry and promoting a major restructuring and reorganization of the agricultural sector although, to be sure, these problems are historical and structural, and defy easy solution. Rapid agricultural transformation and rapid growth of agricultural production are needed to modernize the Cuban economy and will come largely from new activities. Badly needed are small to medium-scale firms. The challenge of restructuring will be to effectively close most of the old structure and allow for the expansion of the new one.

III. Establishing an Appropriate Emergency Setting: International Mediation for Reconciliation, Disarmament and Distribution of Relief Supplies

Unfortunately, there is a high probability of widespread violence in Cuba owing to the communist party's intransigence, coupled with the current U.S. policy toward Cuba. This brings us to the need for a timely and appropriate response from the international community to accelerate basic elements of the transition with widespread acceptance from the population.

As has been pointed out in several papers and presentations made at meetings of the Association for the Study of the Cuban Economy (ASCE), in news reports and elsewhere, there is a strong sense of nationalism in Cuba today. These sentiments have been exacerbated by the U.S. trade embargo on Cuba, and recently by the Cuban Democracy Act of 1992. Quite apart from other considerations, this strong sense of nationalism, while probably not sufficient to defeat it, would tend to undermine the usefulness of a U.S.-led mediation effort in Cuba. Although Cuba is an integral part of Latin America --notwithstanding its exclusion from, or non-participation in, the Organization of American States (OAS) and the Inter-American Development Bank (IDB)-- and Latin American governments are keenly interested in "bringing Cuba back as a full-fledged member of the community," its suspension from the former might complicate reaching an agreement for a mediation effort by the OAS. Were this to be the case, the United Nations would be able to marshal the required international mediation effort, and it could do so led by key Latin American and European countries.

Although for many years there were attempts at setting guidelines for United Nations operations, as a result of tensions among superpowers, the UN's mediation activities have traditionally been of a largely *ad hoc* nature, depending on the specific circumstances of each case. They have ranged from a one-person fact-finding mission to peacekeeping forces of up to 20,000 troops. A careful examination of previous and current experiences of the UN and regional organizations is sure to yield valuable insights into the most effective ways of accomplishing desired goals. Although the OAS peacekeeping action in the Dominican Republic originated from a unilateral intervention on the part of the United States, a precedent which many feel clouded inter-American relations and weakened the OAS for many years, the characteristics of that particular operation may hold valuable lessons for a UN/OAS-sponsored effort in Cuba.[\[47\]](#)

One key element in the establishment of a multilateral mediation operation is precisely how it is generated. The Dominican Republic case cited above is not a viable scenario. All UN mediation and peacekeeping operations prior to Somalia in late 1992 came about as a result of requests by host governments or authorities of some type. In the case of Cuba, a problem may result if there is a sudden political vacuum or other similar change in the leadership. Under these conditions, using their autonomous "good office" powers, the Secretary General of the UN and/or of the OAS might consider quickly dispatching a team including several internationally-respected figures such as Latin American Nobel Peace Prize winners Rigoberta Menchú (Guatemala), Oscar Arias (Costa Rica), Alfonso García Robles (Mexico), and Adolfo Pérez Esquivel (Argentina), and current and former heads of state such as Patricio Aylwyn (Chile), César Gaviria (Colombia) and Felipe González (Spain), whose joint presence might generate a more formal request to the UN or OAS from various parties in Cuba and give the mediation effort a significant boost in credibility and support among the population of Cuba and in the international community as well.[\[48\]](#)

The terms of reference for a UN/OAS mediation mission in Cuba should include: (a) mediation to achieve the **formation of a National Reconciliation Council or coalition government**; (b) **disarmament of the internal security, paramilitary apparatus and population**; (c) management of a **Special Emergency Relief Fund** for distribution of basic necessities to the Cuban population; and (d) assistance in the **organization and monitoring of elections** within a relatively brief but prudent time period. At the outset, it will be important to determine the specific objectives of the operation so that once accomplished, the mediation effort may be terminated and UN/OAS forces and/or international observers can be withdrawn.

For there to be a true reconciliation, a general amnesty should be granted to the armed forces, members of the communist party and to government leaders not directly responsible for egregious human rights violations or corrupt practices, in return for a *meaningful* acceptance on their part of a return to an environment of respect for human rights, representative democracy, and a market economy with social justice. A large team of international monitors should make sure that human rights are respected, prevent retaliatory acts against former officials, facilitate an orderly exodus of the principal persons responsible for the Cuban debacle, and provide basic monitoring of compliance from all parties involved.

A National Reconciliation Council (CRN) or coalition government should include: military leaders, whose leadership will be essential in achieving peace and disarmament and providing law and order; reform-minded members of the National Assembly (*Asamblea Nacional del Poder Popular*), some of whom are knowledgeable concerning details required for implementing actions and policies; leaders of selected important groups or institutions in Cuba, such as labor unions, other worker organizations and student groups, whose active participation in a "social pact" during stabilization will be critical; leaders of human rights and religious organizations, who may be instrumental in an early effort to distribute relief supplies; and Cuban expatriates.[\[49\]](#) All members should be beyond reproach in terms of direct responsibility for human rights violations and corruption, and committed to disarmament, reconciliation among all Cubans and peaceful transformation to democracy and a market-based economy. This will be a time when leadership of unquestioned integrity is needed.

The CRN or coalition government should establish and appoint members of provisional councils to propose and implement policies during its period of tenure. One such council should be in charge of economic policy and structural reform; another should be in charge of privatization. In view of the considerable impact that international relief programs have on the local economy, this particular council should liaise closely with UN/OAS authorities.

Disarmament is necessary to achieve reconciliation in Cuba. Although the military apparatus is also crumbling, the country is an armed camp. In addition to army, navy and air force regulars and reserves, which total approximately 300,000, Ministry of the Interior troops totalling about 6,000, another 35,000 internal security and special police troops, para-military organizations in Cuba include an additional 1,300,000 persons. Disarmament should be undertaken under UN/OAS auspices, involving elements of the Cuban armed forces as mentioned above in Section II.C.1, as part of a comprehensive plan.

A Special Emergency Relief Fund should be established to receive, manage and arrange for distribution of food, medicines and other necessities donated by the international community. Relief supplies will be required for a period of approximately six months following termination of the present government, until domestic production of food and foreign exchange availability are reactivated. Management of this Fund should include the careful determination of requirements, bearing in mind the impact of free distribution of foodstuffs on local production in scheduling a rapid phase-out, as well as careful planning and monitoring of the distribution itself in order to ensure that the donations go to the most needy and do not further encourage an already active black market or discourage local production.

IV. Conceptual Framework and Basic Strategy of the Proposal for a Radical Transformation of the Cuban Economy to Achieve High and Sustained Growth with Equity

"...the early talk about 'big bang' solutions was largely the result of ignorance of the real situation. In fiscal policy, there cannot be any big bang solution, since before new policies can be introduced, new institutions must be created."[\[50\]](#)

Vito Tanzi, Director, IMF Department of Fiscal Affairs

A. The Activist Role of Public Policy in Guiding Stabilization and Systemic Reform Efforts

The economic and social welfare of Cuba will depend largely on its own efforts in the redirection of its human and natural resources to peaceful living and on the effective management and implementation of economic policies and reforms. Aid to Cuba will be contingent upon full utilization of its indigenous resources. A broad-based, eclectic approach, synergistic interaction, with a significant degree of overlap and close collaboration between the private and the state sector will be an engine of growth and most useful to propel Cuban economic development. Economic development is impossible without broad cooperation.

Cuba needs to achieve sustained and high rate of economic growth over many years to bring its very high unemployment and underemployment rate down to a manageable level and to be able to provide high quality social services on a solid basis (health, education, housing and social security).

One area where government must intervene systematically and function well if markets are to operate effectively is in controlling key macroeconomic variables, mainly inflation and balance of payments disequilibria to attain and maintain internal and external balance, because as liberalization progresses, the potential for instability becomes more generalized. Hence, it is necessary that the government's capability to design and implement economic policy and market-friendly reforms is strengthened and improved. It should guard against the disruptive influence of distributional coalitions. A determined, energetic and effective government, working with a private sector and independent labor unions, can do more than markets alone to make reforms work in favor of rapid stabilization, robust recovery and sustained growth. Public

policy needs to be imaginative, courageous, pro-active and effective in putting systemic reform policies into effect and making selective interventions to promote growth and to correct failures in the working of markets.

A number of deliberate, temporary, credible and well-chosen interventions will be needed to promote the desired transition within the context of support for competitive markets. During the transition period, the government should adhere to strong macroeconomic policy and systemic reform positions and have the capability to influence the actual development process. It will be extremely important that the government acts on the basis of clearly defined and well-known objectives as regards stabilization, capital accumulation and general welfare of the population.

It is generally agreed that a stabilization program should precede most other measures.

B. Core Concepts

1. Stabilization

From the outset, it is convenient to distinguish between stabilization and structural adjustment (or institutional and liberalization reforms). Stabilization centers on short-run macroeconomic policies designed to control aggregate demand, that is, in reducing expenditures that close the expenditure/production gap (or eliminate macro-rationing) and move the economy toward an equilibrium position. Macroeconomic stability is a necessary but not sufficient condition for robust recovery and sustainable growth. It encourages the economic agents to take a long-term stance providing the essential framework for private investment. To start and sustain growth, people should be motivated to work harder and to save more. Price stabilization makes people engage in productive activities with a longer-term outlook, rather than in speculative short-term ones that take advantage of inflation. Lack of stability depresses foreign investment, promotes the dollarization of the economy and capital flight, and undermines long-term lending by financial intermediaries, leading to low investment and stagnation or slow growth. However, unless required structural adjustments take place, stabilization measures alone cannot lead the economy to a feasible and sustainable growth path and many distributional pressures will develop.

There are two critical components in designing a stabilization program. First, the primary concern must be to achieve stability, not to promote immediate employment expansion and growth. Stabilization policies work mainly on the demand side to reduce inflation and external deficits. A focus on promoting expansion and growth at the outset of the program can easily undermine the effectiveness of a stabilization program and lead to failure. However, as stabilization measures take effect and prices of most goods and services are liberalized, some measures should be adopted to trigger output expansion, mainly through mobilization of external resources for key export activities, in order to create a positive, dynamic process. Second, measures taken to restore stability must not conflict with long-term reforms because they can easily destroy credibility. Such would be true, for instance, if as a result of stabilization measures, the country were to maintain widespread price and wage controls and other prohibitions and regulations, which are incompatible with the aim of promoting a competitive, dynamic, market-oriented economy. However, there is a delicate trade-off, because some ad-hoc measures that are inefficient in the medium term (e.g., some price, interest rate and foreign exchange controls) can be very effective in the short run, minimizing the stabilization adjustment costs by creating incentives to a greater or more purposeful effort of labor, avoiding destabilizing capital flight, and reducing the inertial effects of initial price liberalization and other adjustments to avoid hyperinflation. [\[51\]](#)

The depth, diffusion and persistence of economic disequilibria in Cuba (latent unemployment, misdirected production patterns, trade imbalance, monetary overhang and debt overhang) must not undermine confidence that a well-designed and appropriately implemented stabilization program can succeed. One goal of the program must be to reduce queues and rationing of consumer goods and to stabilize prices and the exchange rate immediately. Another goal is to create a more stable environment for financial deepening, which involves the monetization of the economy and the increased demand for domestic financial assets, thereby facilitating the inflow of external savings and stimulating domestic savings and investment, in turn establishing the basis for a robust and sustained recovery.

The experience of developing countries suggests that macrostability may easily unravel if institutional and liberalization reforms that must be initiated to resume long-term growth, are inadequate. In recent years, some stabilization programs have stopped inflation in Latin America, but have not improved the prospects for long-run real growth. There is the risk that adjustment policies will generate "stabilized stagnation" if economic policies do not consider structural and inertial features.

Stabilization from the current situation should be judged to be successful (a) if the inflation rate is reduced to an annual rate equivalent to 30/40 percent during the first months after the initial price jump associated with liberalization of prices, (b) the budget deficit is sustainable with non-inflationary financing, implying a level of less than 4 to 5 percent of GDP, and (c) the current account deficit is covered by orderly external financing. It will be necessary to monitor closely the behavior of the inflation rate, the public sector deficit, the level of net international reserves, the real exchange rate, the real interest rate, and the index of economic activity.

2. Structural or systemic reforms

Structural adjustment is concerned with the supply side, and seeks to enlarge productive capacity by increasing mobility, adaptability, flexibility and efficiency in the utilization and allocation of resources among competitive uses. It seeks to eliminate distortions in incentives, enhance the role of market forces, and improve microeconomic efficiency. Hence, it concerns changing the existing equilibrium position to increase aggregate supply, specifically tradable production, and increasing the rate of growth through a wide range of actions in order to remove rigidities and distortions. There is a very important relationship between economic and institutional variables. The transition to a market economy is simply not a matter of economic policy measures; important new institutions are required to promote the capitalization, modernization and opening of the economy:

(a) The capitalization or the increase in savings and their channeling to the most efficient investments. The depletion of the physical capital stock must be stopped. To boost the rate of economic growth, sufficient expansion of productive capacity through investment must be one of the primary objectives of the reform process. But equally important is the mobilization of adequate saving to ensure the realization of required investment and to make it more accessible to non-traditional investors. Institutional and legal changes are necessary to mobilize domestic and foreign savings and ensure a better allocation of saving. A proper real interest rate policy can be very critical in influencing not only short-run changes in spending, inflation, and external financing, but also in affecting longer-term accumulation of financial assets and the level, composition and productivity of investment. Also important are specific policies that increase the inflow of external savings, whether as capital movements, private lending, foreign direct investment, or official development assistance. Because public investment will account for most of the investment for some time, a cost/benefit analysis system of project evaluation and competitive public bidding procedures are essential elements of the strategy to enhance the quality of public investment.

(b) The modernization or the increased flexibility, decentralization and efficiency in the use and allocation of productive resources, which requires a change in the prevailing prices and in the role of the private and public sectors. This implies an elimination or reduction of constraints on factor mobility and use, administratively determined prices, distortions between domestic and international prices, artificially determined real exchange rates, most government interference (prohibitions, regulations and controls), as well as reducing the relative size of government activity within the economy. Price liberalization is needed to eliminate micro-rationing. The liberalization process will tend to feed on itself as the removal of barriers to imports raises the degree of internal competition and hence the elasticity of domestic supply. The state should assume a subsidiary role in the economy, getting out of activities that the private sector can perform in a more efficient way. Government should be more dynamic and active in the remaining areas based on a more effective management, better organization and improving the quality of social expenditures. The advantage of marketization lies not only in its allocative efficiency, but also in its facilitation of innovative and creative activity (technological change).

(c) The internationalization or the opening to international trade and foreign investment of the small Cuban economy and its integration into the world economy to promote technological catching-up. Cuba must allow the import and sale of foreign goods, services, and technologies to promote internal competition and exports to the rest of the world, and to encourage foreign firms and individuals to invest in them. The outward orientation is a necessity arising from the smallness of its domestic market and limited natural resources. It needs a production system able to follow the international rhythm of technical progress and to face global competition. A liberal trade regime is likely to impose discipline on the domestic producers by unleashing the forces of competition. Cuba needs a reorientation toward a structure of production in line with the country's comparative advantages. While the expanding role of exports can stimulate economic growth, successful economic performance also

depends on favorable internal conditions and the expansion of all types of goods and services.

There are some advantages of backwardness and being a latecomer. Cuba can take advantage of a great wealth of technology, project management, policy and development experiences from countries that started earlier. Cuba can do a lot of technological catching up; it does not have to proceed by trial and error, which is more costly. Time and effort could be saved by Cuban reformers by borrowing from the experiences of East Asian countries and early reformers in Eastern Europe. However, comprehensive and orderly changes in the economic system and policies are necessary to realize the full potential of being a follower. A chaotic transition could provoke unforeseen social and political consequences. Extensive and premature liberalization could exert serious adverse effects in the short run on production and the financial situation of enterprises. A vicious circle would result in escalating stagflation and increasing political pressures.

C. The Fundamental Strategy: Consistent Policies and Sustained Reforms and Modernization

Many stabilization attempts were doomed to fail in Latin America and Eastern Europe over the past twenty years, either because they lacked internal consistency or because they were not sustained. Indeed, Latin Americans have been subjected to frequent harsh doses of austerity only to find the sacrifices they had to endure were fruitless. The dynamics of change in disequilibrium markets is very difficult to model and there is simply no full theoretical model to do it. Formal economic analysis has little to contribute here, and economists have paid the issue scant attention. Potential conflicts and tradeoffs among various stabilization policies and structural reforms -- the so-called "composition of instruments problem"-- need to be minimized, and it is important to take advantage of synergies and complementarities.

A coherent, consistent, and complete set of policies and well-developed program of systemic reforms is proposed to encourage economic agents to respond to transformation needs. A core concept is to work simultaneously in several areas with accurately-timed and coordinated measures in each area, within an integrated policy framework. In terms of results, isolated policies do not compare favorably to those generated by interactive policies. In many countries, stabilization attempts did not succeed because they were not part of a long-term economic strategy. Once the urgent and immediate problems such as a balance of payments crisis or severe inflationary pressures were solved or significantly reduced, policies were abandoned. Often measures were not carried out to reverse policies and alter institutions that had strenuously resisted market mechanisms for decades and kept intact a labyrinth of impoverishing rigidities and deep distortions in the economy. Thus, a successful stabilization program must be comprehensive and viewed not as a single act but as a process, the first stage of a new growth strategy. The relevant economic agents must be persuaded that the program can work and that the government is determined to see that it will do so.

Achieving stabilization in Cuba will require two clearly-defined phases:

1. Phase 1: Emergency Period -- Rehabilitation and Adjustment for Stabilization

On "A-day" (A for adjustment) several measures should be introduced **simultaneously** to: (a) liberalize or adjust prices; (b) establish a hard-budget constraint both to the central, provincial and local governments and to state enterprises; (c) open the economy to foreign competition and remittances; and (d) start rationalizing the allocation of resources. Because their effects are mutually supportive, it is futile to attempt one or more of them in isolation from the others. This emergency (very immediate-term) program should begin immediately and last only a few months (e.g., six months). It should also streamline administrative powers, promote law and public order (protection of life, individual liberty and property), while humanitarian assistance (medicine, food and clothing) and concessional resources and grants from multilateral institutions are mobilized to alleviate pain and suffering, and prevent famine and disease. This assistance should be seen as limited and transitional.

The emergency program would be designed to bring quickly to a halt the anticipated hyperinflation that would result once price controls for small and medium-size state firms are lifted, and prices for large enterprises are significantly adjusted, and it would be accompanied by a reduction in public expenditures, the establishment of a competitive foreign exchange rate, the imposition of a few taxes, the enactment of a stark monetary reform, the freezing of public sector wages, and the establishment of a positive real rate of interest. The problem is to persuade the relevant economic agents of the difference between a once-and-for-all increase in the level of prices and a rise in the rate of inflation. Also, some important but limited institutional changes are required to ensure that the proposed macroeconomic policies can be implemented and will work.

The argument for a decisive stroke early in the transition process is the necessary restoration of macroeconomic and microeconomic equilibria after more than 30 years of rationing and imbalances. Economic policy should provide individuals and firms with a relatively stable and reliable macroeconomic framework.

The proposed emergency stabilization program is cautious, and relies on five initial anchors rather than just one, as would be suggested by neoclassical theory, to bring about a rapid, coordinated and definite end to inflation: the exchange rate, fiscal balance, tight credit policy, nominal wages of public employees, and prices of goods and services provided by large state enterprises. These five initial anchors should alter the dynamics and inertia of the inflationary process after the initial price adjustment.

The purpose of this first phase is to reach a stage in which inflation is positive but low and not accelerating. Accelerating inflation should not be allowed because it badly distorts investment decisions and entrepreneurial activity to the detriment of economic recovery and long-run development. External transfers and capital inflows (including foreign financial assistance and grants) should be sufficient to cover the current account deficit and the required increase in international reserves to sustain the exchange rate. The public sector budget deficit must be reduced and its investment portion financed partly by foreign capital and partly by borrowing from the financial sector. Once the first phase is completed, the remonetization of the economy could begin again in order to end inflationary pressures.

2. Phase 2: Short to Medium-Term-Consolidation of Stabilization, Initiation and Diffusion of Structural Reform, and Modernization[\[52\]](#)

We consider it necessary to emphasize that what is important is not necessarily urgent. Therefore, we make a distinction between matters of importance and matters of urgency in order to avoid the evils of unnecessary haste. However, we consider that policies and reforms should be implemented as rapidly as possible on all fronts to take full advantage of the general public's support for change. We propose an orderly structural and modernization reform program (liberalization, institution building, privatization and restructuring of firms) to sanitize and invigorate the economy and avoid a roller-coaster behavior in the main markets and sectors.

Phase 2 consists of a subsequent short to medium-term program, lasting up to three years, to consolidate the stabilization begun in **Phase 1**, and to carry out basic and comprehensive institutional and liberalization reforms to totally remove the current restrictions to private sector activities and to investment and growth. Unless the underlying causes of inflation (i.e., the huge public sector and the lack of adequate incentives and institutions) are fully addressed, temporary freezes of the nominal exchange rate, public salaries, and prices of large state enterprises will reduce inflationary expectations temporarily, but once removed, inflation will rebound. Each of the suggested measures reinforces the others. If adopted together, the measures can be successful; if adopted singly or over time, they are doomed to failure. These reforms should be implemented as early in the process as possible. However, it must be stressed that the complete benefits of structural reforms aimed at increasing the flexibility and responsiveness of the economy take time to emerge. This period could be a time of both stability and rapid growth resulting from robust recovery.

Structural reforms essential for long-term stability and the resumption of economic activity and growth encompass: (a) a new tax system with a view to promoting capital formation; (b) a complete reorientation, reorganization, and modernization of the public sector, including streamlining management and administrative procedures and bureaucratic controls in support of economic growth, together with the consolidation of an effective social safety net; (c) increasing the role of market forces in productive sectors, but also in providing public services; (d) new institutional arrangements for establishing, operating and developing private enterprises and competitive free markets; (e) privatization of productive and public service state enterprises; (f) drastic liberalization of domestic goods and factor markets, financial markets, the exchange rate, and foreign trade; and (g) settlement of foreign claims and foreign debt renegotiation. However, some of these measures, especially (e) and (f), must **not** be started until a basic stabilization suggested for Phase 1 has been accomplished. Two distinct supply-side forces could be freed by the reforms: a rapid accumulation of capital stock and, second, a powerful adjustment in the structure of incentives.

Cuba needs a decisive export strategy (based on tourism, agricultural products, etc.) to break the foreign exchange bottleneck and to be the driving force in a sustainable economic growth. Increasing foreign exchange availability leads to higher levels of imports, which in turn will allow higher levels of investment and economic activity. It

should be remembered that most of the Cuban economic expansion after the 1920's was based on terms of trade improvements (1935-1953 and 1965-1985) and the expansion of sugar production (1965-1985). That is to say, the 1935-1953 and the 1965-1985 growths were based on a protected market with very high artificial prices.

In this phase the previous short-run relief efforts should be replaced by multi-year financial assistance for recovery and development which could play a key role in starting an era of prosperity, and political and social stability in Cuba. Foreign assistance could also stimulate the growth of private investment and provide the necessary assurance that the program will succeed.

A listing of policies and reforms recommended is shown in Table 5. Cuba must sooner or later adopt measures such as these to modernize its economy and to be effectively reintegrated into the world economy. Table 6 presents a summary of the **medium-term** effects of those policies on four major objectives-- reduction of inflationary pressures, recovery and expansion of production, improvements in the balance of payments, and employment generation.

V. Economic and Social Policies for the Emergency Period and the Short to Medium-Term

If you don't know where you're going, any road will get you there.

-- Cheshire Cat, in *Alice in Wonderland*

This proposal consists of what the authors consider is necessary to establish a social market economy in Cuba, that is to say, an economy that emphasizes free markets, stability and transparency of rules, and with an emphasis on competition and social justice where these need not be spontaneous byproducts of free markets. The problem will not solve itself simply by letting the economic system grow up spontaneously. A strong commitment or pledge will be required that as the economy expands all social groups will benefit. The program should make clear that the government intends for all to share in the benefits of growth. We do not support growth at any cost, but rather growth combined with increased socioeconomic equity. The transformation to a market economy should not enrich a few and impoverish many.

This commitment will have a very important self-reinforcing feedback. Moreover, the economic system must be consciously shaped. Reliable long-term decision-making requires a stable price level, a stable real exchange rate, and predictable fiscal policy. Distributional conflicts must be finessed. However, due to space constraints, some important issues will not be analyzed in depth in this paper.

The program assumes that Cubans will be in charge of designing and carrying out the stabilization and structural reform program. Given the economic uncertainties and lack of updated and complete information on the Cuban economy, specific recommendations made at this time will no doubt require adjustment once all available pertinent information is gathered and analyzed.^[53] Nonetheless, the general shape of the recommendations is clear. We need to acknowledge that the tasks that lie ahead pose immense long-term challenges.

A. Significant Reduction of the Public Sector Deficit and a More Effective Public Administration (Modernization of the State)

Immediate control and eventual elimination of the public sector deficit --estimated to have reached almost 16 percent of GSP in 1990-- will be a *sine qua non* condition to eliminate the flow problem of excess demand (personal income greater than production) or inflationary monetary finance and to prevent a price-wage-price spiral resulting from price liberalization. This control will also ensure credibility of the aggregate demand policy consistent with disinflation. The fiscal and quasi-fiscal deficit financing has been the ultimate cause of the current monetary overhang and repressed inflation. A restrained fiscal policy should be oriented toward avoiding any additional pressures on the money supply to reduce the risk of inflation and create conditions for the development of the private sector, and make possible the implementation of important measures including privatization, deregulation, and reduction of the government role in the economy, which should be implemented in a short time. Unless the deficit is decisively reduced, it could cause financial markets and investors to fear (correctly) that it will lead to more inflation in the future.

Table 5.

PRINCIPAL MEASURES RECOMMENDED FOR STABILIZATION AND INITIATION OF STRUCTURAL REFORMS

<(Will be available soon.)

Table 6. Medium-Term Effects of the Economic Policies Recommended

Reduction of Inflation	Recovery and Expansion of Production	Employment	Generation	Improvement of Balance of Payments Broad-based fiscal austerity	a/ ? - - +	Over-devaluation and foreign trade orientation reform b/	- + + +	Tight credit and high real interest policies	a/ ? - - +	Price and wage adjustment	c/ - - +	Proactive export policy	d/ ? + + +	Foreign debt renegotiation and settlement of claims	e/
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Effects: -- negative, + positive, ? unclear

a/ It reduces aggregate demand and is deflationary; however, it could have inflationary effects through cost increases (working capital costs, value-added taxes and tariff adjustments).

b/ It increases prices, improves balance of payments and, depending on the elasticities, could increase production.

c/ It should improve resource allocation and utilization in the country and external competitiveness through increases in efficiency, but should increase prices.

d/ It selectively increases aggregate supply.

e/ It finances increases in aggregate demand with foreign exchange.

f/ It finances increases in aggregate demand and aggregate supply with foreign exchange.

g/ It increases aggregate supply through administrative and technological modernization but privatization should create unemployment.

h/ It increases aggregate demand and employment.

The most administratively feasible measures to cut the fiscal deficit are: (1) elimination of all subsidies and transfers to enterprises and most of those to households, and significant reductions in public expenditures; (2) sizeable increase in prices of goods and services produced by state enterprises; and (3) installation of a new efficient and effective tax system to finance central, provincial and municipal government expenditures. If taxes are inadequate to balance government budgets, inflation and financial chaos will erode Cuba's ability to recover and reorganize its economy.

These actions, which require the consolidation of public order and the overhaul and strengthening of the Ministry of Finance, will relieve the pressure of financing the budget deficit and will also show the resoluteness of the stabilization program in tackling a difficult and enormous problem. Given the huge size of the public sector in

Cuba, its adjustment (i.e., reduction) is essential in the stabilization effort. A complete and detailed budget by activities and enterprises should be prepared, together with a strict system of expenditure control and monitoring implemented by the establishment of budgeting and accounting units in all ministries and the creation of an autonomous body of auditors.

There are two alternatives for basic balancing of the budget by limiting governmental expenditures. First, the government can **reduce current expenditures (i.e., subsidies, military and internal security expenditures, administrative expenditures and transfers)**. Second, the government can trim investment projects and reduce the public payroll across-the-board. The first alternative should be attempted before cutting the payroll and investment in economic and social infrastructure, which is likely to hurt long-term growth and could crowd out private investment because of complementarities and other effects. By increasing the profitability level, public expenditures in productive services and social sectors can "crowd in" capital formation by the private sector. Cutbacks in already scarce public investment, combined with high interest rates and low capacity utilization, will discourage private capital formation. An essential question will be how to restore public investment in physical and human capital with associated externalities, while maintaining fiscal responsibility. There should be an effective freeze in net government hiring. Spending agencies must be under effective budgetary control and should not have direct access to foreign capital markets or to the financial system.

Fiscal discipline requires elimination of subsidies or of the cash deficits of state-owned enterprises. This, in turn, will bring about the rationalization of prices and incentives. Simultaneous **price liberalization of small and medium-size state enterprises** aims at reducing unjustified and costly government subsidies, improving efficiency and competitiveness, and assisting the stabilization process by moving the level and the structure of prices in line with production costs and closer to opportunity costs.^[54] These enterprises will act independently, subject to the discipline of market forces. They will be free to select inputs, to change the product mix, to hire and fire workers, and to set their own prices. They must pay their employees and taxes out of their net income and their borrowing must come from lenders who will expect to be repaid. Managers must reorient their thinking toward profits and losses. Clearly, letting firms make their own decisions does not make any sense unless the firms are subject to hard budget constraints and bankruptcy and liquidation.

Sharp increases in prices of goods and services produced by large state enterprises and in public utilities rates (electricity, oil, transportation, telephone, water and sewerage, mail, etc.) are necessary to end the fiscal drain on state enterprises, yet full price liberalization for these enterprises should be postponed until effective competition or regulation is established, because it will tend to be more socially disruptive than economically efficient. Even in developed mixed market economies, large state-owned enterprises are often not very responsive to market forces. Hence any further price increases should require prior authorization.^[55] Prices for non-tradable goods and services should be based on the long-term marginal cost of producing them. Boards of directors should be put in charge of large state enterprises and allowed to act independently.

Swift price adjustment has many advantages. It quickly improves the finances of state enterprises, and will cause larger reductions in real money balances and inflationary expectations. The cost of this necessary adjustment can be faced during the Emergency Period, but would tend to be destabilizing to an elected government. If stabilization is achieved after this initial correction, prices will not have to be increased again for some time. The adverse social effects of the price and utility rate shock should be offset by the consolidation of the social emergency program to carefully focus relief on lower income groups (e.g., pensioners, female heads of household, handicapped and disabled people, etc; see Section V.L). However, some of the decrease in apparent real wages would not result in a decrease in welfare, but rather that prices would clear markets and rationing would disappear.

With respect to **tax reform**, a comprehensive, but simple and neutral (in relation to current expenditures) tax system can also contribute to resolving the fiscal problem, but it will take time. Given the inevitable weakness of tax administration at the early stages of reform, simplicity and collectability are key criteria. At the outset the government should define simple accounting and auditing rules for reporting for taxation purposes and should provide incentives for the pre-payment of taxes --especially payroll, withholding, and estimated corporate taxes-- to overcome the inflationary erosion of tax revenues due to lags in tax collections --the so-called Olivera-Tanzi effect. Indexing taxes and imposing stiff penalties for non-compliance should also be considered. An immediate option is to introduce a few **simple sales, excise, and personal property taxes** (e.g., on motor vehicles, residential property, oil, spirits, beer, tobacco products) that could be collected while a comprehensive tax system is being designed. The purchase of automobiles and houses is a clear indication of an ability to pay, and possession is easy to verify.

The basic concept underlying the tax reform is to place the tax burden in the sphere of indirect taxes in order to stimulate entrepreneurial activity. The backbone of the system should be an **across-the-board 20 percent value-added tax**. **Personal and corporate incomes should be taxed at a slightly progressive rate averaging 30 percent of incomes**. Alternative combinations may be explored, such as a higher VAT (e.g., 25 percent) and lower personal and corporate income taxes (e.g., 25 percent). There should be an incentive so that retained profits become the major source for financing business investments. **There should also be stiff taxes on luxury consumption**.

The main problem of the tax reform will be the capability of the tax administration to audit private and public sector activities. Compliance with tax laws would be ensured with a carefully prepared tax administration program. This is an important area for technical cooperation from multilateral institutions. At the outset of stabilization, it will be essential to **establish an internal tax service** with accompanying accounting rules, to collect taxes from households and liberalized state enterprises, with staff drawn from the production ministries that previously were in charge of overseeing state enterprises. Special incentives should be given to avoid inefficiency, fraud and corruption. An institute for training tax auditors should be created, since Cuban government officials have proved to be notorious in their poor command of basic accounting and auditing rules and procedures.

New firms should be required to register to pay the value-added tax for obtaining and maintaining an operating license. This should also be a condition for privatization. All these businesses should also be required to withhold personal income taxes from their employees and to pay the withholding tax and the estimated corporate income tax monthly to the Ministry of Finance.

The government must be very careful not to spend more than what has been collected or what has been soundly financed. A law should be enacted to forbid the government to finance the budget deficit by printing money; mandatorily the budget deficits, funding investment rather than current expenditures, would have to be financed by the emission of government bonds, treasury bills and foreign debt. In addition, legislation should **establish a ceiling for the budget deficit of 3 percent of GDP**. This 3 percent of GDP deficit ceiling rule, which is a most important anchor, must not be relaxed, because to do so would create contradictory signals, result in a loss of credibility, and crowd out credit to private firms (and thus reduce private investment). The government already faces a heavy burden in financing the public health and education systems, infrastructure, debt repayments, the social safety net that supports dislocated workers and guarantees minimum consumption levels for all citizens, and the painful restructuring of public sector activity.

Cuba needs to embark on a far-reaching reform of the executive branch of government in an effort to modernize the State and to ensure the accountability, efficiency and transparency of government institutions. During **Phase 2**, Cuba must **reorient, reorganize and modernize its public sector to increase efficiency in public expenditures and investment; streamline and rationalize procedures; decentralize some economic decision-making by expanding the authority of provincial and municipal governments with linkages with civil society; and streamline personnel**. Special consideration should also be given to the treatment of transparency of information on public sector reform. The government should concentrate on "public goods" activities, use **cost-benefit analysis to select public investments, and establish public bidding for public procurement**. Table 7 summarizes the main changes we propose for expenditures in the education and health sectors. Similar changes should be made for other sectors and activities.

The size of the military establishment must be reduced to a fraction of its current size. Reforming government should aim at scaling down its personnel and making the public sector a small, flexible and responsible catalyst to support initiative and change rather than being an obstacle. Government's responsibilities are to stimulate growth, equal opportunity and taking care of citizens in need. Choice, competition and market incentives should be gradually introduced to the public sector through innovations such as public school choice, social services vouchers, partial payment for health expenditures, etc. The problem is one of "governance," or how effectively and efficiently the government operates, not simply of the bureaucrats. The government procedures and rules should be clear, succinct, simple and non-discriminatory. A central element of public reform is the elimination of institutions and state functions that are not consistent with a market orientation.

Thorough civil service reform is required to replace the political bureaucracy, which exercises the powers of government over the people based on the concept of a proletarian dictatorship, with high-quality technocratic officials devoted to the concept of service to the people, led by a democratically-selected executive branch insulated from political interference. A country the size of Cuba should have a streamlined central government with no more than 100,000 to 150,000 civil servants. Total compensation including pay, perks, and prestige, should be competitive with the private sector. Recruitment and promotion must be merit-based and highly competitive.

A listing of the policies aimed at slashing the budget deficit and bringing it under control is presented in Table 5, Section 1.

Table 7. Cuba: Summary of the Proposed Changes in Education and Health Policies

	Current Situation	Proposed Changes	
State role	Benefactor. The state determines, finances and executes all services.	Facilitator. The state determines and finances public expenditures. There should be an increasing role for the private sector for executing public expenditures.	There
Priorities	Expand universal coverage. Increase infrastructure.	Improve quality. Rationalize expenditures. Improve cost recovery.	
Mode of state participation	Centralized decision-making and delivery of services.	Centralized decision-making and decentralized execution by the municipalities.	
Relationship between social and economic policies	Virtual disassociation.	Social policy should be integrated with and complementary to economic policy.	
Level of social expenditures	Expanding.	Initial adjustment and rationalization. Further expansion should depend on macroeconomic situation.	
Private sector role	Almost none.	Increasing and active role in the execution of social expenditures. It should provide most services to high and medium-income groups.	
Allocation of resources	Supply driven: Direct subsidies to the supply of services based on historical experience.	Demand driven: Preference to subsidize demand based on the amount and quality of services provided. Allow more choice and market orientation.	
Access to the system	Universal.	Marked preference for the most vulnerable. Initial emphasis in detailed identification of this group.	
Targeting	Not a priority. Nominally all programs have universal coverage.	Most vulnerable: aged, disabled, female heads of household, abandoned children.	

B. Reform of the Exchange Rate Regime

When a country has persistent and increasing current account deficits that become impossible to finance and sustain, external adjustment is unavoidable. The reduction of external disequilibrium requires an adjustment of domestic absorption to local production levels. This generally implies a contraction in aggregate demand of tradables (i.e., imports) in the short run, and an expansion in aggregate supply of tradables (i.e., exports and goods and services that compete with imports) in the medium and long run to solve the external disequilibrium and reduce the current account deficit. Cuba's tradable sector, based on an outward-looking strategy in which non-sugar expansion will be the engine of economic growth and development, will be central to the restoration of growth. The real exchange rate level is a very important strategic policy instrument.

A sharp devaluation would encourage trade by generating changes in relative prices, in the allocation and utilization of productive resources, and in the composition of the consumption basket. It should boost the level of economic activity by providing incentives for the production of tradables as well as reducing demand for imports by making them more expensive, thus encouraging the consumption of domestically-produced products. Although these effects help reduce the disequilibrium in the external sector, they are not symmetrical: while demand for imports decreases quickly, exports increase more slowly, because it is necessary to convert labor and capital to export-oriented activities. Furthermore, in the case of Cuba, a reduced internal demand resulting from stabilization policies will not release large quantities of domestic production for potential buyers overseas. Among the negative effects of devaluation are the inflationary pressures that it generates by making imports (especially intermediate and capital goods) more expensive and raising the local currency cost of servicing the external debt. However, devaluation will set the economy in the direction of greater export orientation over the long run.

The disorganization that will accompany painstaking economic reconversion and restructuring will temporarily affect the economy's ability to export and increase its need for imports. A free or clean float policy would introduce a large additional element of uncertainty in an already uncertain economy. The domestic foreign exchange market is relatively small, and the exchange rate will be determined by speculative pressures, not by the behavior of exports, imports, or long-term net capital and transfer flows. Furthermore, liberalizing foreign exchange markets might lead to hyperinflation as the flow/stock disequilibrium between foreign incomes and debt is large. Wealth-holders will prefer to store funds abroad because they will consider foreign financial institutions as being safer and more efficient than domestic ones. Until the domestic capital market matures with borrowing and lending at equilibrium rates, free foreign exchange convertibility on capital account is inappropriate.

A temporary fixed exchange rate to the US dollar provides direct stabilization to the price level, both because it is a highly visible price whose stability can help settle down expectations, and because it ensures that the prices of imports will rise only at the external (i.e., U.S.) rate of inflation. In an economy where all prices will be based on the dollar, fixing the exchange rate temporarily and sustaining it is an effective way of stabilization. A stabilization fund should be established for that purpose. It is important to distinguish between a nominal and a real devaluation. Although a nominal devaluation produces a real devaluation in the short run, the real devaluation can

be eroded very quickly, especially in an inflationary environment. Transforming a nominal devaluation into a real one requires the use of fiscal and monetary policies, validating the devaluation.

The exchange-rate anchor is needed most in the early stages of stabilization and should be moved to a crawling peg, depreciating the exchange rate at a pace that maintains external competitiveness, by small changes at frequent intervals, mainly to compensate for differences in the rates of inflation. The most important objective of exchange rate policy must be to avoid significant overvaluation of the currency and make it predictable. A real exchange rate with a competitive stable value is a very important stimulant to exports by providing a favorable environment for investment and marketing decisions. **This level should be altered from time to time, certainly at the beginning of Phase 2**, to set a real rate deemed to be consistent with a medium-term outlook for terms of trade, interest rates and the availability of foreign transfers and financing. The exchange rate should not be used to brake inflationary expectations. It must be supplemented with direct trade promotion policies such as tax drawbacks, as well as state interventions to improve infrastructure and the overall economic environment for key exports (see Section V.F below).

Therefore, four changes in exchange rate policy need to be implemented during the stabilization phases: (a) unification, (b) initial over-devaluation, (c) subsequent managed crawling peg, and (d) partial convertibility. **Unification of the exchange rate** for all transactions will remove an important source of deep economic distortions. **Over-devaluation** will insure export competitiveness and guarantee adequate build-up of foreign reserves; therefore, the *Banco Nacional* must identify an operational range of the equilibrium real exchange rate that will serve as a basis for the **introduction of the crawling peg** in the foreign exchange market. **Partial convertibility with some exchange rate controls**, similar to the Czechoslovakian experience of 1990-1993, will allow the gains in international reserves to accommodate the increased demand for domestic currency and will reduce the potential inflationary effects that will result from the *Banco Nacional's* accumulation of international reserves. Premature deregulation of the foreign exchange market could lead to capital flight, speculation and financial instability. The proposed partial convertibility implies almost full convertibility for trade transactions on current account, but limited convertibility on capital account. [\[56\]](#)

The exchange rate should be used to anchor domestic prices during the first three to six months of the stabilization program. This policy should be reinforced by temporary freezing the level of domestic credit of the *Banco Nacional*. Therefore the initial devaluation must take the exchange rate to a level higher than the equilibrium level (initial exchange rate overshooting) in order to help jump-start exports, which would be useful in the early period. [\[57\]](#) In this way, the real appreciation level that will inevitably occur when the exchange rate is temporarily fixed, will not endanger trade competitiveness nor the accumulation of international reserves. When real appreciation reaches a preset level, the timing of which will depend on the initial degree of overshooting and on fiscal and credit discipline, the fixed system must be abandoned. It is better to do this early and gradually, that is with a passive crawling peg with gradual, periodic adjustments or some mechanism of administered float, than with a strong and sudden devaluation.

By undervaluing the peso, doing business in Cuba will seem like a bargain to foreign investors, and Cuban goods should find eager markets abroad. Therefore, integration into the world economy will be hastened. Cuban production must become internationally competitive if the country is to enjoy the benefits of development. The way to achieve this goal in the long run is not through real wage cuts but through improvements in worker skills and productivity. This calls for better development of productive resources, investment in plant and equipment, and labor training, as well as a pro-active export promotion policy (see Section V.F below).

At the initial stages of the program, the exchange rate controls are necessary to avoid capital flight as well as speculation and instability. Partial convertibility means that all Cuban enterprises and households would have free access to foreign exchange for the purchase of foreign goods and services, but not for the purpose of buying assets abroad or holding foreign currency. However, foreign firms operating in Cuba should be allowed to repatriate 100 percent of their after-tax profits. Obviously, a system of controls over the purchase and sale of foreign exchange and appropriate monitoring would be required to ensure that foreign currency is used for the permitted purposes (needed imports). In practice, this would limit the amount of foreign exchange that Cuban citizens could acquire for foreign travel. [\[58\]](#) Cuban residents (firms and households) who earn foreign exchange abroad should be required to sell that foreign exchange to the *Banco Nacional*, unless they receive permission to retain it for investment or other transactions abroad. Initially, Cuban residents should not be permitted to hold foreign securities or large quantities of foreign currency originated in foreign exchange earned in Cuba. Other sources of foreign exchange would be official conversions from private financial remittances, direct foreign investment and borrowing abroad.

Any other restrictions from the foreign exchange market should be removed to safeguard the stabilization program's credibility and to facilitate remonetization of the economy. In this sense, the *Banco Nacional* should accumulate sufficient reserves to defend the currency from speculative attacks. Initially a fund based on borrowed funds might accomplish this. However, if the initial devaluation is sufficiently large and if monetary and credit policies are consistent with the new exchange rate via a sufficiently high interest rate for domestic currency deposits and foreign capital inflows, the probability of speculative attacks and the need for stabilization fund will diminish.

A summary of measures recommended to reform the exchange rate regime is presented in Table 5, Section 2.

C. Establishment of an Open Foreign Trade Policy

Gradual, but continuous and decisive, opening of the economy to foreign trade and competition is an intrinsic component of a robust transition to a market economy and its integration into the international system. Consequently, it should receive top priority in order to reap the benefits of specialization and modernization and to maximize efficiency. This opening will provide new quality standards, supply high-quality inputs, resources, and other skills not available domestically. It can be an effective way to import a rational price structure and to limit the monopoly power of domestic firms.

The first phase of trade reform will contribute to the realignment of relative prices by reintroducing foreign competition into an excessively protected and extremely inefficient domestic market, including breaking the traditional foreign trade monopolies of state-owned foreign trade firms and organizations. Everyone would have the right and be encouraged to pursue foreign trade. Thus, the government should immediately **eliminate non-tariff barriers for imports** (e.g., licenses and quotas), except those clearly justified by sanitary and safety reasons or by national security rules (e.g., arms). These measures would help eliminate existing price distortions and increase fiscal revenues and would constitute the first steps of a **six-year trade liberalization program aimed at a unified 10 percent tariff rate**.

An immediate and complete liberalization of trade is likely to cause a severe adjustment cost. A more reasonable approach would be to **establish two orderly and gradually decreasing tariff levels** (e.g., initially 100 percent for consumption goods and 20 percent for intermediate and capital goods) until a low uniform tariff level of 10 percent prevails. If the tariff is reduced step-by-step according to a clear and preannounced schedule, the producers will have strong incentives to impose efficiency and adjust to increasing foreign competition.

The idea of squeezing inefficient producers and enterprises and making them either restructure or disappear is a very important rationale behind opening to foreign competition. However, a reasonable time should be provided for reconversion. The major part of Cuban manufacturing industry and agriculture is extremely inefficient, obsolete and/or of low quality by world standards. Cheap primary raw materials prices (especially for oil) existed for a long time and had a very strong impact on the choice of technology, and therefore an immediate transition to world market prices resulting from a very competitive open economy would inevitably mean elimination of the bulk of current Cuban production.

The schedule of tariff reductions should be fixed in advance and be non-negotiable to the enterprises, although the pace of tariff reduction across all sectors might be accelerated for macroeconomic reasons. [\[59\]](#) To avoid blunting the incentive to export at the new exchange rate, a **system of import duty and VAT drawbacks** should be introduced, whereby the tariffs and the VAT are rebated when a product containing an imported input or a national input is exported. Measures should be adopted to reduce port-related costs.

The adoption of a commercial policy along these lines, together with the associated changes recommended, would hasten Cuba's **active participation in the General Agreement on Tariffs and Trade (GATT)**. The U.S. is Cuba's natural and potentially main trading partner. **Once the U.S. embargo is lifted**, Cuba should **negotiate preferential access to the U.S. market under the Caribbean Basin Economic Recovery Act** and try to **integrate its economy to the North American Free Trade**

Agreement (NAFTA) as early as possible.

The measures specified above are recommended to open the economy, encourage exports and facilitate reintegration to the world economy, and are listed in Table 5, Section 3.

D. Prudent Management of Monetary and Credit Policies and Building a Stable and Secure System for Financial Deepening

Inflationary pressures are not only generated by differences between flows of personal income and production, but also from a stock/flow disequilibrium between a large money stock and current production as reflected by a high monetary stock/GSP ratio.^[60] The current large monetary overhang, estimated by the government at 14 times the monthly wage bill, will tend to generate a dramatic increase in prices, especially after prices are liberalized. The magnitude of the structural and relative price changes required raises a major problem of setting off a subsequent inflationary spiral. Therefore, **a monetary reform, or an equiproportional increase in all prices and wages by a factor of 3 to 4 times**, is needed to establish monetary balance by a drastic syphoning off of excessive purchasing power, thus allowing the reestablishment of a working financial sector. It should precede the price adjustment recommended in sections V.A and V.E; cancellation of all debts and credits of state enterprises would reduce the pressures generated by the enormous size of the money supply (the stock problem of inflationary pressures) and hence the initial price adjustments and their inertial effects.^[61] Only then might a new monetary unit be introduced to increase confidence and consolidate expectations. Additionally, a monetary reform provides a practical way of revising or rewriting contracts that no longer reflect a fair deal between debtors and creditors and of avoiding internal inconvertibility of the peso if prices are not adjusted fast enough; it would also tend to improve income distribution.

Rules for expanding and managing credit and interest rates must be specified because they will support the stability of the exchange rate and promote the remonetization of the economy. The expansion of the credit base should only reflect increases in international reserves during the first phase of stabilization. There should be no increases in net domestic credit from the *Banco Nacional*, except for exports from small and medium size firms that have export orders verified by letters of credit. In other words, remonetization should only take place through increases in international reserves, and the *Banco Nacional's functions in this area should be limited to those of a currency board* (i.e., selling and buying foreign exchange at the exchange rate).

Initially, in the Emergency Period, prices of public services and of goods and services produced by state enterprises will rise and the exchange rate will increase, and as a restrictive credit policy is imposed, there will be a monetary squeeze and real interest rates will rise. Higher interest rates will encourage external capital inflows as firms and individuals use credit to rebuild the real level of their production activities and monetary holdings. Any **real interest rate policy should be coordinated with exchange rate policy** to avoid destabilizing capital inflows.

Budgetary stabilization alone cannot stop inflation if the *Banco Nacional* expands credit by lending to state enterprises or to the private sector. It is necessary that state enterprises face a hard budget constraint and begin to restructure. However, as soon as fiscal correction is attained, monetization can be achieved consistent with disinflation. Monetary policy should target real interest rates, leading market rates to levels that are deemed compatible with the exchange rate and fiscal adjustment previously described. As long as the exchange rate and the interest rate remain stable, monetization should be allowed to continue. Money creation will be the counterpart of monetization of capital inflows and private credit creation. Monetary and credit policies should strive for positive real interest rates on domestic currency deposits so as to strengthen remonetization and support stability of the real exchange rate. Moreover, a positive real interest rate on loans would eliminate the financial subsidy that is one of the sources of the quasi-fiscal deficit.

High real interest rates early in the stabilization process may generate an outcry for an expansion of domestic credit --which should be denied. High real rates are unavoidable, and the more credibility there is that the program is serious and strongly backed by the government, the sooner the nominal and real rates will fall. However, rapid interest rate liberalization (floating real interest rate) may pose problems when there is limited competition in the financial sector and inadequate regulatory and supervisory mechanisms. Because high interest rates do, however, have a number of costs for the economy, putting a ceiling on lending rates in the short run may help avoid the consequences of adverse selection, in which healthy firms will refuse to pay very high real interest rates while weak firms with little to lose will accept very expensive loans to stay alive. They could also fuel inflationary expectations, deter private investment, and put pressure on the *Banco Nacional* to rescue commercial banks that run into trouble (especially in the presence of some type of deposit insurance), which would in turn endanger monetary and credit discipline and the attendant risk of pervasive bankruptcies and financial instability. Therefore, it will be necessary to regulate interest rates to have a kind of mild financial repression (keeping interest rates positive, but low) and to avoid misallocation of capital by channelling credit to activities with high social return, especially exports, but to do so in such a way that rates are high enough to help stabilization succeed by encouraging households to place savings in the financial system, discouraging capital flight and rationing credit efficiently. A preliminary financial liberalization would endanger trade reform. This regulation should involve a **ceiling for lending rates**. Banks would have to ration and direct credits to minimize the risk to their portfolios, giving priority to export activities. Also, some institutional measures to encourage savings should be used, such as limited availability of consumer credit and mortgage loans, at least for second homes.

The effect of the rising interest rate could also be limited by introducing a financial indexation to inflation plus a real interest rate. In this way, the market would determine the *ex-ante* real interest rates. Thus, a successful program that takes sufficient time to convince people will not have to suffer the consequences of extremely high *ex-post* real interest rates. **Indexed financial instruments should be made available** soon to savers, as well as other assets that are safe, convenient and generate attractive returns. Deposits and loans denominated in foreign currency will provide an additional arbitrage mechanism to prevent increases in interest rates for loans denominated in domestic currency.

There is a need to establish institutional safeguards against inflationary policies and to ensure their solvency to encourage financial savings. The *Banco Nacional should be autonomous or independent of the government and of all political bodies and the sole provider of legal tender; the state commercial banks would also be independent* to signal the repudiation of the previous accommodating monetary policy. The *Banco Nacional should be prohibited from granting credits to cover government deficits*. Lower government borrowing releases resources for the private sector. Initially, credit to public enterprises should be available on a short-term basis only to profitable enterprises at market interest rates, with no subsidy involved and more stringent collateral and project evaluation requirements as the term lengthens. If commercial banks do not receive government subsidies and are forced to survive on their commercial skills, soft loans will suddenly disappear or be reduced to manageable proportions. The government should **establish and monitor the legal framework for implementing appropriate reserve requirements, strict credit regulations and high interest rates on loans for consumer activities, and, at least initially, high capital requirements for commercial banking, saving banking and insurance companies activities to insure their solvency, including setting accounting, disclosure and reporting standards for business results**, and enforceable auditing, thereby determining the legal and financial conditions and requirements for entry into commercial banking in Cuba. Only then will a two-tier banking system and an ordinary monetary policy with discount rates work.

Branches of foreign banks should be authorized to help the process of trade financing, essentially based on the risk of the importer outside Cuba, or to finance working capital for exporting companies that can offer their future export revenues as collateral. However, at least initially, they should not be allowed to accept domestic deposits.

Increases in prices of goods and services, along with devaluation and monetary reform, will contract the real money supply. If this contraction is accompanied by a significant reduction in inflationary expectations through a strict fiscal policy, the current monetary disequilibrium will be reversed and there will be an excess demand for domestic currency. This is a necessary initial condition for remonetizing the economy. The adequate management of monetary and credit policies after this initial correction constitutes a necessary condition for success. At this point a fixed money growth rate rule imposes unnecessary costs in terms of lost output.

Although nominal interest rates will probably fall after the initial stabilization phase, real interest rates will remain much higher than world rates because of higher risks and scarcity of loanable funds. As credibility increases and loanable funds expand, real rates will fall, and as real interest rates fall, demand for money will rise. The *Banco Nacional should allow remonetization to occur*; the experience of all successful stabilization programs supports such a policy. Thus, economic authorities should not pick a monetary stock target instead of a domestic credit target and a real interest target. In fact, most remonetization should occur as a counterpart to increases

in foreign exchange reserves, with a simultaneous domestic credit expansion occurring due to a higher transactions demand for money.

The expansion of credit should continue to be tied to increases in reserves during the second phase of the stabilization program, which must begin when the fixed exchange rate is abandoned. However, **domestic credit should be increased gradually to higher proportions of the gains in international reserves.** The objective is to accommodate the increased demand for domestic currency in the most rapid and most expansionary way possible. The partial convertibility of domestic currency will enable Cuba to avoid or significantly reduce the inflationary effects caused by increased domestic credit. Domestic credit should be channelled through a rediscount credit line, thus enabling the *Banco Nacional* to exert influence on the behavior of the market rate of interest.

Since private households are likely to become net dissavers, the government should **promote the establishment and development of a private pension fund system**, based on individual accounts, to provide long-term capital and credit to entrepreneurs opening private businesses or to efficient state enterprises with sudden budgetary shortfalls. Pensions should be determined on the basis of the funds that the subscriber has accumulated in an individual account throughout his (her) life, plus the earnings from the investment of these funds in the financial market. Participation in the private system should be obligatory for all new entrants into the labor force. Workers should be allowed to leave the government-run system and make tax-deductible contributions of 10 percent or more of their salaries to the new system with deductions withheld at the source. Those who make the switch must be fully compensated for the contributions made to the old system by the government at the time of retirement with an "acknowledgment bond." In this way, the average worker will have a self-interest in the success of the private sector and will therefore be more willing to support policies that enhance economic growth rather than those that simply redistribute income.

Private, specialized pension fund management companies (PFMC) should be required to invest pension contributions in a low-risk and diversified portfolio of corporate bonds and stocks, mortgage securities, bank CDs, government bonds, and treasury notes. PFMC should be subject to minimum capital and profitability requirements and should be financed on the basis of commissions collected from their subscribers, with appropriate normative and supervisory controls and regulations through a superintendency. As the funds become stronger, their resources could be invested in a much wider range of financial instruments and sectors, especially those related to exports.

Also, competitive capital markets should be strengthened by the **creation of a stock and bond exchange**, guaranteeing open exchange operations, supervising participants, and defending the rights of small investors, mainly by providing them with free and timely access to information. The creation of mutual funds and private pension funds will be natural ways for people to hold an equity position in firms.

It is very important to give incentives to private investment at a time of high real interest rates and a credit crunch. This could be provided through a low tax on corporate income (e.g., 30 percent), tax incentives for reinvestment, accelerated depreciation schedules, and privatizing assets at prices below their market value and preferential credits to finance new exports.

The monetary and credit policies presented above are summarized in Table 5, Section 4.

E. Price and Wage Adjustment Policies and Liberalization Labor Reforms

The Cuban government currently determines all prices and wages. Getting rid of extreme price and wage distortions appears to be a necessary condition for greater tradability of domestic production. Consequently, **all price and wage controls and regulations for private enterprises should be eliminated** on "A-day," at the beginning of the stabilization program. After an initial increase in the price of public services and in the prices of goods and services produced by monopolistic large state-owned firms takes place, prices should be frozen during the first phase of stabilization, thus acting as an additional nominal anchor. As for wages, the **nominal wages of public employees should be frozen** --thus also acting as a nominal anchor-- both because the ownership of state enterprises is ambiguous and firms will tend to pay excessive amounts to workers, and because eliminating inflation requires that "apparent" real wages reflect "effective" real wages. [\[62\]](#)

All compensation in kind should be converted to cash payments and abolished thereafter. Measures undertaken to correct competitiveness or to reduce the budget deficit can be effective only if they reflect realistic real wages. Unless real wages reflect the scarcity cost of labor in the short run, a significant increase in unemployment will take place. To cure unemployment of the classical type, one should raise prices or lower wages. During **Phase 2, any increases in real wages of employees of public enterprises and central government should be determined by productivity gains.**

The government should negotiate a "social pact" with labor unions and other groups that would place a **temporary moratorium on strikes** during the stabilization phase, explaining the emphasis that the government will give to the social safety net to favor the unemployed and the lower income population in order to ease the transition. This pact should temporarily hold profits and wages in line and give credibility to the sustainability of the stabilization program by providing political support to the reform. The government should **support the establishment of free and democratic labor unions and other workers' associations. Labor laws should be enacted to provide security to workers in sickness, disability, old age and involuntary unemployment, as well as provisions to make it easier to hire, dismiss, and reassign workers.** Institutional and legal rigidities (such as prohibitions or restrictions for temporary and seasonal employment) affect the responsiveness of employment and wages to economic factors. The government should also encourage labor participation in enterprise reform.

Labor unions should have the right to negotiate working conditions and wages basically without government interference, even without compulsory arbitration by the government. If everything is deregulated but labor, Cuba could end up with the "New Zealand disease:" local businesses are overwhelmed by foreign imports and foreign investment is scared away. Therefore, in order to be more concordant with a competitive environment associated with a market-oriented economy, the Cuban economy must rely more heavily on a decentralized and flexible wage bargaining process and a fluid inter-industry labor mobility. Also, the resolution of property rights in housing and the creation of a housing market are very important to facilitate the reallocation of labor.

Establishing private and public labor market information systems and private employment services is very important to speed up the labor reallocation resulting from stabilization measures and painful economic restructuring.

To be most effective, price liberalization requires that small and medium-size state enterprises be reconverted immediately into independent, self-financing, and profit maximizing organizations. These enterprises should definitely be privatized during the first part of **Phase 2** (see Section V.K).

Price and wage policies are summarized in Table 5, Section 5.

F. The Need for an Active Export Promotion Policy

For more than 30 years Cuba existed under an umbrella of politically-determined and heavily subsidized trade with the socialist bloc without any stimulus to increase productivity and foreign competitiveness. Key export activities have become obsolete from a technical point of view, are undercapitalized, or their comparative advantage has eroded (see Section II.F). The lack of foreign exchange has metastasized the entire economy (transportation --lack of oil and vehicles--, communications, electricity, and spare parts crises). Therefore, in an effort to hasten growth, economic policy should be biased in favor of exports, at least temporarily; removing and anticipating bottlenecks, and revealing potential growth areas. However, the non-tradable support activities (distribution, transport, financial, communications) must be competitive. Export expansion is the key to success and together with related investments should be the main engine of future economic growth. Using any realistic exchange rate, Cuban wages are very low by international standards. A similar comparison of skilled workers' wages might be even more striking. Add to this the proximity of the Eastern U.S. and thus low transportation costs.

Exports are a powerful mechanism to increase investment and to acquire and absorb foreign technology. Cuba must quickly develop efficient sources of foreign exchange generation in very competitive world markets in order to reverse further shrinkage of its economy and to modernize its productive apparatus to catch up with world market levels of technology and investment. Thus, Cuba should focus its resources on restructuring and reconverting its key economic sectors. When accompanied by

appropriate exchange rate and other sound macroeconomic policies, special inducements can assist in sustaining export-led expansion in the initial stages prior to introducing major structural reforms.

Robust recovery needs a foreign exchange stimulus to get started, but growth and modernization require plenty of it. Without sizable export expansion, the economy will soon hit a hard ceiling (or constraint) once its requirements for new plant and equipment exceed the meager and obsolete installed export capacity. In the short run, the sources of foreign exchange are traditional exports (sugar, tourism, nickel, cigars, fisheries, and citrus fruits) where Cuba has some specialization and experience.

The Cuban government must make an in-depth assessment of these activities to determine how to rationalize, recover, and expand them and how to increase their competitiveness in world markets in order to determine selective industrial promotion and export-push trade policies. These goals can be attained through **management and labor training; rapid and intensive applications of easily available technologies and techniques; by updating and expanding the capital stock**, if warranted; by **establishing an appropriate institutional framework and business environment**; by **promoting trade agreements** with friendly countries and by **providing new exports automatic access to credit**. Institutional support in dealing with bilateral and multilateral negotiations affecting market access should be provided by a streamlined and modernized Ministry of Foreign Trade. Cuba also needs to **promote research, development and application of technologies to improve its main exports**, to support their channels in world markets, as well as the **enactment and enforcement (certification) of quality, sanitary and health standards and controls**, all of which fall beyond the budget of small firms.^[63] Medium/large enterprises should be expected to cover the full cost of services.

The scope and speed with which technological change and innovation are incorporated into firms to drive them by innovation will be a major determinant of recovery, and eventually of growth, through changes in productivity. Diffusion, absorption, and adaptation of new technologies will facilitate flexibility toward change and innovation on the part of top executives, middle managers and staff, and will create new attitudes and behaviors to achieve the depth of economic reconversion required in export activities. A comparative advantage in skill-intensive activities can only be established if the stock and quality of human resources improve.

Technical training and research institutes are essential to absorb and diffuse knowledge throughout society from the outside world, particularly education and training to enhance the capacity of farmers to adopt innovations. The government should utilize tax incentives, selective subsidies and shared-risk credit allocations to encourage technological incorporation by innovative firms. With adequate incentives the private sector should move intensively into technology transfer in agriculture. Cuba should move gradually from low-technology, labor intensive activities to capital- and skill-intensive activities.

During the relatively brief period when principal exporting activities still remain under government management and public property, they must be treated as any private business would (reduce costs, expand sales, increase profits, etc.). Managers should receive incentives to cut costs, to install quality-control systems, to shift resources among product lines, and to meet financial obligations. Workers should receive incentives to learn new skills, to change occupations, and to perform well on the job. Chains of production that run through design, production, marketing, distribution and service should be reviewed to maximize efficiency, cost effectiveness and competitiveness. However, any new investment or major replacement of capital stock should be based on cost/benefit analysis techniques and should have a high real rate of return.

The policies recommended to encourage export expansion and modernization to assist in the reconstruction and development effort by breaking up the foreign exchange bottleneck are presented in Table 5, Section 6.

G. Foreign Debt Renegotiation and Settlement of Claims

Normalization of relations with the international community should make Cuba once again an interesting place for real and financial investments. Cuba's foreign debt overhang and U.S. compensation claims on confiscations of property discourage foreign private investment and commercial loans because they suggest that eventually some combination of higher taxes, interest rates, currency depreciation, and lower domestic demand will be required to effect the necessary external transfer of resources. In view of the very heavy external burden Cuba has to service, absent debt and claims forgiveness and rescheduling, it is literally impossible for it to take off, to have a chance for recovery. Besides, Cuba needs to rejoin the multilateral financial community.

A new Cuban administration should work immediately with foreign creditors to renegotiate its interest and debt repayments and allow it to break out of the vicious cycle of lack of loans and default. **Negotiation and settlement of foreign claims and debt renegotiation** (debt write-down, debt restructuring, debt service reduction, and a temporary moratorium) are needed to smooth the path to market-oriented reform, improve the credibility of the stabilization program with private investors, and contribute to feasible exchange rate, interest rate, and fiscal adjustments by diminishing the uncertainties about future policies. **A support group of friendly countries from the Paris Club and from commercial bank and suppliers should be engaged to prepare a suitable financial package.** This "Cuban Brady" package should cover the reduction of debts and rescheduling of debt amortization (possibly similar to the "enhanced Toronto terms" for dealings with the Paris Club and the commercial banks), "new-money" loans by banks, short-term commercial credits having a higher priority than old debt, and terms and conditions concerning maturity and interest rates for each part of the package to get Cuba back on its feet.

Until the financial package is completed, Cuba should obtain concessional grants to meet its immediate food aid needs and humanitarian assistance. **Once negotiated, Cuba should start using the financial package** to help overcome the severe shortage of external financial resources to boost its exports. Cuba should **request participation in the Enterprise for the Americas Initiative** (debt forgiveness and access to the Multilateral Investment Fund). Cuba should use **debt/claims-equity swaps** to reduce its external debt with commercial creditors and encourage direct foreign investment in large state-owned enterprises, infrastructure and other development projects. This, of course, is equivalent to providing an incentive (subsidy) to foreign investment.

The policies presented to negotiate claims and renegotiate foreign debt and encourage a renewed flow of external financing to assist in the reconstruction and development effort are included in Table 5, Section 7.

H. Mobilization of Private External Resources

Cuba suffers from lack of hard currency. It cannot import because it does not have the funds. However, there is a significant number of Cuban expatriates with high skills, income levels, financial resources and experience in market economies who could assist in the reconstruction process and the development of a market-oriented economy. Once the U.S. embargo is lifted, proper policies should be developed to attract them and take advantage of this unique opportunity.

The government should **encourage and simplify procedures for direct monetary remittances from Cuban expatriates to their relatives and from international non-governmental organizations (NGOs) to their Cuban counterparts.** These external transfers could play a major role in providing needed humanitarian assistance and foreign exchange.^[64] It could also start a sound expansion pulled by externally-financed consumption.

It will take some time for Cuba to reestablish its previous reputation as a financially sound and reliable country. The government should make a concerted effort to encourage the flow of foreign capital, especially in the form of foreign direct investment and medium and long-term capital movements. Also, joint ventures and technological tie-ins with foreign enterprises should be encouraged. The value of such flows lies both in the foreign exchange they provide as well as in the technical, managerial, and marketing skills they can provide to Cuba.

Cuba needs rapid acquisition of technology, managerial improvements and access to international markets through openness to direct foreign investment, licenses and training. Simply by using the available resources more effectively there will be great growth in productivity. The government should **adopt a foreign investment law** to attract new investors based on providing equal treatment for foreign investors and nationals, facilitating the free movement of capital returns, expediting market deregulation, providing foreign investors with contractual certainty and clear property rights. Initially, Cuba can offer a good mix of low-cost labor and high productivity. However, the strongest incentive to invest in Cuba would be its potential for growth and the possibility of acquiring state-owned firms at a fraction of their actual international market value. Specifically, the new legislation should seek a three-year limitation on investors withdrawing their initial capital investment (unless there is a

liquidation), and no time or quantity limits on profit remittances. It should provide a loss carry forward, or that any losses suffered by the taxpayer in a given fiscal year may be deducted from profits earned in the succeeding three fiscal years. Also accelerated depreciation should be provided.

The government should formally **join the Multilateral Investment Guarantee Agency (MIGA) and invite and sign agreements with the Overseas Private Investment Corporation (OPIC) and other similar European institutions** to start financing and insuring investments in order to eliminate the country risk of investing in Cuba. Cuba should also **sign the International Convention for the Settlement of Investment Disputes (ICSID)**. Discussions should begin immediately, with the aim of **securing bilateral investment agreements** to avoid double taxation in order that foreign investors can receive credit for the taxes they will pay in Cuba from taxes payable in their country of origin.

The policies included in Table 5, Section 8 are recommended for Cuba to encourage the inflow of private foreign capital and remittances.

I. The Potentially Decisive Contribution of Financial and Technical Cooperation from Multilateral Institutions

Cuba needs conceptual help, fresh ideas and assistance in reorganizing its economy. Foreign technical assistance and training can speed up the transfer of knowledge and skills, especially for bankers, managers, accountants, auditors, economists, and corporate lawyers. With the support of multilateral institutions, perhaps under the coordination of the UNDP, **a comprehensive technical assistance and training package** should be prepared to obtain and develop the professional skills needed for transition to a market economy.

It is very likely that Cuba will receive a significant amount of external assistance from the multilateral financial organizations (MFO) in the future. The MFO will be willing to help, because Cuba has an indisputable advantage: it has no current obligations with them and it has a tremendous potential for development based on its educated and skilled labor force, fertile land, and strategic location near the U.S. Therefore, it can obtain a considerable amount of foreign resources from them to stabilize, restructure and modernize its economy, and renew its urgently-needed development process.

Hence, it would be convenient, to save much time and effort and to avoid discussions about conditionality, to put together a consultative group under the leadership of the Inter-American Development Bank (IDB) to develop a medium-term external financial package. This group should design, develop and coordinate not only the external financial package, but also a technical cooperation package from the IMF, the World Bank, and the IDB, as well as from members of the Paris Club. The consultative group could also provide assistance and advice to the Cuban authorities, who have no experience in dealing with these institutions.

Membership in and support from multilateral financial organizations MFO (IDB, IMF and World Bank) can help bring Cuba back into the mainstream of international economic and financial activities. It would give access to substantial resources, in terms of technical assistance, economic advice and financial transfers, some of them on very concessional terms. Access to such types of assistance, advice and transfers would be particularly important, because Cuba will be engaged in a major transformation from a centrally planned economy into a decentralized market economy, as well as in the reconstruction and development of its economy.

A MFO loan program, prepared by a consultative group, could bring the following benefits:

- (a) the MFO advice and technical cooperation, both as external assistance and training, will provide support for designing and implementing a coherent long-term macroeconomic program, enhancing the functioning of government, removing legal, economic and bureaucratic obstacles for private investment, privatizing state-owned enterprises, and ensuring consistency between stabilization and structural adjustment measures through evaluation and endorsement of the program. Unfortunately, most economists in Cuba were trained in the former Soviet Union and other former socialist countries in Eastern Europe, and do not have experience in how to develop, manage and consolidate a market economy. Therefore, Cuba needs technical cooperation from MFO to be able to prepare and implement major stabilization, liberalization and economic restructuring programs. Also, it will need technical cooperation to design, develop and strengthen institutions required to develop a market economy, such as: budgeting, revenue, accounting and auditing systems, as well as project preparation.
- (b) The MFO's seal of approval for economic policies and institutional reforms will enhance the climate for renegotiating the foreign debt, settling foreign claims and obtaining additional funds from export credit agencies, international commercial banks and suppliers.
- (c) The MFO will provide an important amount of financial resources for development projects, especially to improve basic infrastructure and public services, and will act as catalyst for mobilizing additional private funding for those projects. They should include services such as co-financing, loan syndication, floating of funds and other instruments, and identifying investment partners. The balance of payments and development support will generate the amount of import financing Cuba needs if some level of recovery of output is to take place at the take-off phase of the stabilization program.

Transfers of resources from the MFO will raise confidence and fuel greater investment expansion. There is a sort of "demonstration effect" behavior among investors: if some begin to invest, others will follow. External financing could help Cuba out of a stagnation trap enabling it to "take off" despite severe structural limitations to increase internal savings.

Cuba requires special financing to ease the global and sectoral structural adjustment costs and the restructuring of the economy. During the past years, the country has employed backward technologies in the agricultural sector, as well as in the tourism sector, and suffers from major environmental problems, not to mention serious social problems. In some social areas, such as health and education, Cuba has excess installed capacity which should be rationalized in accordance with its level of economic development. In other social areas (e.g., housing) Cuba has major deficits, so it could benefit significantly from sectoral structural adjustment loans.

Furthermore, Cuba could definitely benefit from investment loans and assistance in mobilizing private resources to finance core components of specific basic infrastructure capital-intensive development projects, and also to help develop the small and medium-size enterprises needed to exploit its areas of comparative advantage in the agricultural and tourism sectors. Cuba's infrastructure is crucial, because of its repercussions on cost structures in the productive sectors and hence on the ability of its firms to compete internationally.

It will take some preparation time for Cuba to obtain such funds. Based on experience at the IDB, it would take a minimum of six months for initial assistance to become available.

One major issue concerning the MFO relates to the country classification that would be given to Cuba upon entry. For example, in the World Bank Group, Cuba's current per capita GDP will probably be below US\$800, thus making it eligible for the International Development Association (IDA) concessional resources. These resources represent a grant element of 85 percent, since IDA does not charge interest and there is only a small administrative fee of 0.75 percent against the outstanding balance of credits to meet administrative expenses.

In the case of the IDB, if Cuba were classified as a Group "C" country, it would have limited access to concessionary funding. Alternatively, were Cuba to be classified as a Group "D" country, it could mobilize a significant amount of concessionary lending funds, including from the Bank's Fund for Special Operations. This Fund allows loans up to 40 years with a 10-year grace period at 1 per cent interest during the first 10 years and 2 per cent during the amortization period. The classification can make a major difference because, as indicated before, the current economic situation in Cuba is critical and deteriorating rapidly. Furthermore, debt renegotiation and creditworthiness considerations will inevitably place restrictions on Cuba's ability to assume new obligations.

Based on recent experience in the cases of Nicaragua, Panama and Peru, Cuba could mobilize --assuming it has the absorptive capacity to do it-- about US\$1 billion per year from the main MFO (the IMF, the World Bank, and the IDB). This figure is somewhat higher than the US\$800 million per year suggested by Preeg. [\[65\]](#) A main obstacle is that Cuba, as mentioned before, does not have experience nor expertise in preparing and negotiating the type of technical assistance and long-term loan programs that would be needed.

The policies outlined above are listed in Table 5, Section 9.

J. Undertaking Fundamental Institutional, Legal and Regulatory Reforms

Cuba's current business-related laws are not modern or market-friendly. It will be necessary to design and implement an attractive, modern, reliable and stable institutional environment consistent with a market economy, private property and enterprise that encourages the entrepreneurial spirit, provides incentives quickly for investment and growth, and assure greater participation by the civil society after 35 plus-years of asphyxiating controls. As soon as economic and political liberties are established, Cuban entrepreneurs will surge forward with energy, determination and capacity, disproving the false ideas of Guevara's new man. The government is charged with safeguarding competition by creating open markets, most importantly free trade, free choice of occupation, and free entry to and exit from market activities. Cuba needs an institutional framework that combines market-friendliness, competition among firms and cooperation between government and the private sector.

Creating market-friendly and strong efficient organizations together with the legal and regulatory framework from scratch is a task of monumental proportions that should not be underestimated. Throughout Eastern Europe and the former USSR, an inadequate institutional, legal and regulatory framework has proven a major barrier to stabilization, robust recovery and sustained growth. Cuba had only 1,900 lawyers in 1992, while it had 43,000 medical doctors. The current microeconomic features of the Cuban economy (allocation mechanisms and incentives, ownership arrangements, price and wage setting, and organization of the financial system) tends to nullify or distort the effects of conventional macroeconomic policies. The positive impact of stabilization, price and trade reforms on aggregate supply response will be short-lived unless the internal deregulation of private markets and a new system of incentives are put in place simultaneously.

The purpose of these reforms is to establish and develop the basic institutions and mechanisms so that the private sector is able to play an increasingly dominant role. Privatized enterprises work well only after a society has established the institutions that are needed for an efficient private sector. Moreover, these institutions are essential if a society is to reap the full potential of the many new firms that every thriving economy must have. Thus, as many changes to the legal system as possible should be prepared and enacted quickly to launch an effective change of the economic system. These reforms should reduce significantly and redefine the role and effectiveness of the state in the economy. The government should be activist, but not big, a decentralizing authority actively fostering partnerships between the private and public sectors to solve specific problems. Early choices may have profound long-run consequences.

Cuba specifically requires an educational reform to foster freedom of inquiry and training in the ability to analyze critically. Education should promote an independent spirit and respect for the value of individuals. Education should also be well-focused on the acquisition and mastery of technology and technical skills. Tertiary education should be provided largely by a self-financed private system. Educational resources should emphasize improving the quality of primary and secondary education.

The legal and institutional reforms should aim at designing an economic framework with a great degree of flexibility in all aspects of goods and factor markets.^[66] They include **laws for the re-institution of well-defined, basic economic rights and the mechanisms to protect them; secure and enforceable property rules and rights including intellectual property protection** to inspire, motivate and energize people; **laws governing the creation and operation of business enterprises, including free entry and exit to markets, crafts and trades**; and well as **simple and swift procedures to initiate and to terminate business activities; relatively unregulated domestic goods and factor markets**, except the minimum necessary conditions and standards to protect public health and safety and to assure that firms will pay value-added and income taxes; **labor laws without constraints on temporary and seasonal employment and labor mobility; privatization of large state enterprises; effective contract enforcement and swift dispute settlement mechanisms**, including assignment of liability for wrongful damage;^[67] **decentralized production and distribution structures; appropriate accounting and auditing norms and procedures** for reporting business results to banks, investors and tax authorities; and **basic civil, commercial and bankruptcy laws** that trigger conditions under which a firm will be liquidated or will undergo a significant reorganization. Modernization and streamlining of the judicial system will remove an important obstacle to regulatory enforcement.

The government must set fair, simple, clear and non-discriminatory rules for market competition for everyone; it should not favor the privileged. The rules should strive to reach an intermediate position between a hands-off view that market forces can do everything, and one that considers that government can solve all problems. In general, the role of the state is to support private sector development through basic infrastructure, tax incentives for research and development, investment, etc., rather than becoming directly involved in productive activities.

The agricultural sector must experience high growth and productivity improvements. The government should guarantee farmers permanent rights over the land they occupy and start a program of land and titling distribution inspired on the MacArthur agrarian reform in Japan, as well as other agrarian reforms in East Asia. The first step towards democratization of the economy is the modernization of agriculture, for which purpose land reform is urgently required to increase land-owning by self-cultivating farmers. As stated previously, in our opinion a restitution program is likely to result in a flood of claims that will strain administrative capacities and impede the clarification of property rights thus discouraging investment for years to come.

Competition and personal responsibility fosters personal creativity. Competition is a vital force for a market-oriented economy, and some steps need to be taken as early as possible to introduce and develop competition in the Cuban market. One of the central elements in the reform process must be the **creation of an anti-monopoly agency** entrusted with the restructuring and partitioning of existing monopolies and enforcing a vigorous competition policy, prohibiting enterprises from colluding, predatory pricing and other abusive business practices, and **establishing a regulatory framework and policies for natural monopolies**. The conversion of armaments production and military complexes into commercial concerns is also important to establish a foundation for competition.^[68]

Promoting small and medium-scale units is desirable because competition among small and medium-size firms is likely to be vigorous and also their ability to adopt swiftly to changing circumstances. The freedom to engage in different activities and to establish small firms would also provide an important source of growth and a shock-absorber for unemployment. Competition among enterprises will begin to develop, leading to improved productivity. Small firms not only can help create and maintain a competitive environment, but can also promote multi-products, small-scale production and increased profits from division of labor with large enterprises. Therefore, the government needs to have policies that encourage the formation and expansion of small and medium-size firms through training and providing temporary technical assistance to them.

Private enterprise should be actively and immediately encouraged, especially in the small and medium-scale production of food, its distribution and sales to consumers (Free Farmers Markets), and in the services and retail sector. Limited markets and informal activities already exist. They simply need to be legalized, expanded, and improved. The high transaction costs currently imposed (through controls, regulations, penalties, and prohibitions) need to be reduced. Also, competition should be introduced into the market and strengthened through the dissolution of the huge state enterprises to ensure a reasonable degree of competition and freedom of enterprise. Not only is monopoly power reduced directly, but smaller units will be easier to privatize through sale.

Liberalization of prices and privatization of state-run concerns are important steps for shifting into a market-oriented economy. However, these measures if implemented under monopolistic conditions are unlikely to produce efficient effects: large companies would be able to raise prices by trimming production after prices are liberalized. Therefore, it is imperative to reform the industrial structure and organization (under the principle that each separate plant is an independent enterprise) at the same time as taking deregulation measures.

One of the most important factors hindering competition among companies is an industrial structure in which manufacturers specialize in a limited number of products and very few companies manufacture a specific product. Another factor that restricts competition is the vertical integration of the production process, with only a small portion of components procured from outside suppliers. A factor contributing to the integration is that heretofore the supply of raw materials was supervised by a large number of ministries and other government organizations under finely and firmly separated jurisdictions.

The institutional reforms should stimulate bigger volumes of investment and that they are used productively. Changes in property rights structures affect incentives for the generation of innovations. Economic incentives should motivate skilled labor and professionals to work more productively and entrepreneurs to mobilize resources and invest.

All these institutional and structural reforms will contribute to long-run economic growth by increasing the flexibility of the economy, its adaptability to change, ability to innovate, and effectiveness in resource use, both static and dynamic.

To summarize, the policies and reforms presented in Table 5, Section 10 are recommended to effect a complete transformation of the role of the state in Cuba, from total domination over the factors of production, to a subsidiary role consisting of orienting the economy, and facilitating development of the private sector.

K. Extensive Privatization Drive

An aggressive and comprehensive privatization program is the essential cornerstone of a broad-based package of structural reform measures to promote efficiency, to depoliticize enterprises (meaning a change in their conduct from meeting the wishes of ideological commissars and central planners to maximizing profits), to distribute private property among the population, and as a very important component of a sound fiscal policy. Privatization and stabilization policies are complementary. Privatization allows the demand for state credit to fall, which in turn makes stabilization possible. Stabilization cripples the political credit mechanism and in this way stimulates painful restructuring. Privatization is also complementary to creating a competitive marketplace and opening to international competition. Common sense suggests that privatization should yield greater gains by allowing more play to the profit motive as market incentives are introduced. It also seeks to transfer effective control over practically all productive processes and selective social sector activities to the private sector and to direct and concentrate the state's resources towards a better fulfillment of its essential responsibility of providing adequate high quality social and administrative services and basic infrastructure. Generalized private property is a sine-qua-non of a functioning market economy.

Cuba should be transformed from a society of public property into a country of property owners. Private firms tend to be more efficient than public firms in the production of most goods and services; hence, the state should not be directly involved in these activities. Although potentially disruptive in the short term, privatization must be carried out relatively fast and in parallel with reforms that provide the necessary institutional framework for the efficient functioning of a modern market-oriented economy. It could be perceived by the population as the only part of the structural reforms that can unambiguously benefit them. By creating a class of supporters for structural reforms and reducing the power of its opponents, privatization can change the political balance in Cuba and allow structural reforms to deepen. It will be important to ensure that privatization benefits will reach all sectors of the population.

An independent and limited duration commission for the promotion and execution of privatization should be created and staffed by serious, experienced, professionally competent, non-political executives who are results-oriented and of indisputable personal integrity. They should manage the process with substantial autonomy, insure the process is consistent with macroeconomic objectives and policies, set specific objectives, establish guidelines and procedures, and provide or gather technical support and supervision. The commission should appoint special committees to plan each process, hire consultants, prepare and execute the individual privatizations, and establish the mechanisms and regulatory framework to foster private enterprise, competition, and stimulate economic efficiency.

The main characteristics of the privatization process should be: transparency and expediency, rapid operational recovery and solid growth of the enterprises, increased participation of workers and management in ownership, correct transfer of ownership rights, non-reversibility of the program and promotion of better social harmony.

The privatization of small and medium-size firms, which will be a sine-qua-non condition for a functioning competitive market economy, requires relatively simple transfer processes based on market parameters. It should be carried out primarily through public auctions (or leases held by municipalities) and should give preference to worker ownership and other Cubans living on the island (small farms; retail shops; transportation, buses and trucks, which may be one of the single most effective pro-competition measures; professional, personal and repair services; entertainment groups, and sport teams). Moreover, foreign corporations should be excluded from participating in these auctions, but may purchase those firms later on. Recognition should be given to the resident's right of possession as the means to claim home, residence or dwelling property before the courts. Small-scale privatization will be very important for the consumer because shopping is very difficult and time-consuming in Cuba today.

The commission should take the responsibility for restructuring --when needed-- the large scale enterprises to boost efficiency prior to rehabilitating and privatizing in the areas where it has comparative advantages: partition, personnel rationalization, and financial reorganization. This can help to obtain a higher price for the businesses and improve the functioning of the financial markets. To facilitate the privatization process, **large establishments that cannot be partitioned should first be corporatized**. That is to say, they should register as joint stock companies with all equity owned by the government, adopt a corporate charter, and appoint a board of directors. Initially, the board would include representatives from the commission (the government's selling agency), the management, the workers, suppliers and customers.

Reputable top-quality international consulting firms and investment banks should be invited to the process as advisors to the commission. A proper pre-qualification process of potential buyers should be emphasized to make sure that the control over the main privatized enterprises stays with able operators with financial capacity and well-known experience in the area that commit to specific plans for future investment. Non discriminatory treatment should be given to all qualified investors who want to participate in the process. **To motivate workers and management to increase productivity and maximize profits of the privatized firm, they should have preferential rights to acquire up to 20% of the share capital transferred** and to pay it with their separation and pension rights. The process should permit participation by small investors.

The privatization of large-scale enterprises (power, communications, railroad, airline, telephone, sugar mills, nickel mines, textiles, tobacco factories, oil refineries, cement plants, banks, water, ports) should be carried out through public bidding to pre-qualified firms for a stock package that will grant a controlling interest in the company. All sales should be carried out through open competitive public bidding and settled in cash. The process should give priority to public services. The widespread distribution of property will be a deterrent against public corruption.

To summarize, the privatization process presented in Table 5, Section 11 is recommended in order to effect a complete transformation of the role of the state from ownership over the factors of production to facilitating development of the private sector.

L. Revamping and Consolidating the Compensatory Social Safety Net

Cubans do not want to turn back the clock to the inequities of the pre-1959 era. Macroeconomic adjustment policies and reforms will entail heavy social costs in terms of increasing unemployment, decreasing apparent real wages, and rationalizing social expenditures, especially in health, education, and social security, because the current level of social expenditures is financially unaffordable given the economic base of the country. Widespread economic insecurity, rising unemployment and social disillusionment brought on by the transition from a welfare state has resulted in electoral victories by communists in Lithuania, Poland and Hungary.

As the economy recovers increasing public expenditures should concentrate on the social sectors. This will complement the trickle-down effect of economic expansion. Unemployment is likely to remain a huge problem after stabilization has been achieved and structural reforms proceed. Absolute poverty should not increase. **Social expenditures should benefit the most vulnerable people**. Social services for high and medium income people should be privatized. Also, there is a great need for restructuring in health and education to allow more choice and market orientation. Therefore, the most urgent need is to improve and target assistance accurately rather than to create of a new safety net.

Lower income groups (the aged, the disabled, female heads of household, and abandoned children) are already suffering from the contraction in the economy, increased open unemployment, falling apparent real wages, and budget cuts. As a matter of social equity, they should not be forced to absorb all the short-term costs that will result from stabilization and structural reforms. Unemployment, homelessness, prostitution, and crime have risen dramatically in recent years and should not be exacerbated during the transition in Cuba. An adequate safety net that provides transfers to support the unemployed, as well as to other vulnerable persons in the reform process, such as pensioners and the disabled, who must be protected against the hardships of a severe inflation, is essential. After the initial price adjustment, pension benefits should be indexed by inflation.

Therefore, the stabilization proposal includes an emergency social safety net to help them and to prevent the real incomes of the poor from falling below the subsistence level. For it to be effective, the lowest-income groups and the poorest must be the principal recipients. For this help to arrive quickly enough, it must be channeled through the existing social network at the municipal level, to insure that scarce resources are received by the most vulnerable. Also the beneficiaries should have an active participation in the program design.

An unemployment support program, to be redefined as soon as possible during the Emergency Period, is a major vehicle for social inclusion and should provide workers who are laid off with a temporary flat-rate benefit support in the form of low-wage employment in rehabilitation of infrastructure or in constructing sites and services to ease the enormous housing problem. The program should also include reemployment services, such as **referrals to job openings, mobility assistance as needed, and training and retraining**, which will provide workers with the upgraded skills and to master new technologies that are in demand or for self-employment, geared toward the establishment of new small firms or micro-enterprises. Participating private firms could finance the cost of on-the-job training defrayed either through tax credits or through direct budgetary allowances.

An unemployment and training system may guarantee both social tolerance and labor market responsiveness to output shifts. However, unemployment support should be below the wages of those who continue to work, decrease with the length of unemployment, and be paid for a limited period to give recipients an incentive to relocate, retrain, and accept alternative employment. The government is currently providing 60 percent of salary for displaced workers.

The policies summarized in Table 5, Section 12 are recommended to alleviate the suffering and dislocation that would otherwise result from stabilization and structural adjustment measures.

VI. Final Considerations

A. Likely Effects of the Proposal

The results of the stabilization proposal would be felt immediately once the fiscal deficit and the monetary overhang are cut and prices tend to be "right." The economy would adjust quickly and growth would take off in the externally traded goods and services. If the measures succeed rapidly, public confidence would be restored and the population would support the program's continuation. However, short-term success alone is not sufficient to ensure long-term stability and sustainable economic growth with equity. For stability to hold and economic growth to take place, liberalization, institutional and privatization reforms are required. Having the fundamentals in place, together with favorable external conditions, sets the stage for success.

An effective stabilization program can achieve price and exchange rate stability very quickly. Indeed, short-term success in stabilizing prices and the nominal exchange rate is feasible, as the Eastern European experiences show. Although some stabilization measures may cause a short-lived burst of corrective inflation, if the adjustment closes the gap between domestic absorption and local production (especially between government expenditures and revenues) and if the monetary reform eliminates the monetary overhang, inflation will soon stop. Most of the corrective price adjustments should be completed within the first six months. Stabilizing the nominal exchange rate is crucial for ending inflation, and the authorities have a good chance of controlling the rate from the very outset of the program. The nominal exchange rate should achieve stability after the initial devaluation. Inflation should then stabilize at a very low rate, but not as quickly, because of the corrective price increases during the first six months of the program and because inflationary expectations and inertia are not likely to collapse immediately, even with the initial five anchors.

High real interest rates are also an unavoidable short-term outcome of a stabilization proposal. They are necessary to lure people to return to the peso. Because the real interest rate and the exchange rate are closely connected, any attempt to lower the real domestic interest rate artificially will make people switch to dollars. The authorities would then be forced either to release reserves or to let the exchange rate depreciate. Neither is a feasible option in a stabilization program. However, if real interest rates remain high too far too long, they will increase production costs (because they increase the cost of fixed and working capital) and, more important, they will induce a further contraction in economic activity. They may also push some firms into financial difficulties because the cost of obtaining new financing or servicing existing debts will increase. The deteriorating performance of such firms will cause serious losses for commercial banks that could eventually require bailouts by the *Banco Nacional*. Further, they could create pressure for real exchange rate appreciation that could virtually stop export-led growth.

The major concern about initial stabilization is that it could further depress production and employment. However, these results are not inevitable. They depend on the way the budget is balanced and the behavior of real interest rates and of the real exchange rate. Furthermore, if an immediate export promotion policy is carried out to beef up exports, private and official external resources are attracted and if foreign exchange and credit resources are channeled to efficient activities, growth will be restored. The effect of these measures is unlikely to have a net contractionary effect. Thus, our stabilization proposal does not necessarily imply further recession.

Also, production of goods and services will be encouraged by the lifting of restrictions and controls on private activity. Production of exports and tradable goods and services will be encouraged by the devaluation and the generalized austerity, while imports will likely be discouraged by the same reasons. The more competitive exchange rate and the recently gained stability will likely lead to a permanent improvement in the trade balance.

Because the goal is to balance the budget on a cash-flow basis and most of the expenditures cannot be reduced immediately, revenues must be increased. However, a reallocation of spending and resources from military, internal security and general political and administrative programs to social programs for low-income groups, is possible. Larger fiscal revenues will come mainly from higher prices of goods and services sold by state enterprises, and from new income, excise, and value added taxes.

B. Some Major Difficulties in the Transition to a Long-term Program for Stable Growth with Equity

Growth in output and efficiency gains expected from liberalization, institutional and privatization reforms will take a much longer time. Although the benefits of achieving stabilization are indisputable, especially in the long term, difficulties in the transition to the long-term program are to be expected.

Labor unrest may develop as "apparent" real wages fall to "effective" real wage levels. To minimize this problem, the government must get early support from the most important labor leaders and unions. The arguments to obtain this support are that labor will, at most, be trading an apparent short-term temporary cost for medium and long-term permanent real gains as the postwar experiences of Germany, Japan and East Asian countries showed; that to continue the status quo will further compromise real wages because wage adjustments cannot keep pace with shrinking production and high inflation and that despite initial apparent declines in real wages, workers will pay much less inflation tax.

If real interest rates remain too high beyond the very short run, a financial crisis may develop. A program for strict capitalization, for legal reserves and for credit regulations of commercial banks will help the banking system face this potential obstacle.

Any slide in the real exchange rate will hurt exporters and those who substitute imports and the trade balance will deteriorate. Although it is necessary to maintain a stable nominal exchange rate initially, at some point this rate should be corrected by a crawling peg. The crawling peg should be enforced to maintain a real competitive exchange rate.

Some groups will also resist economic restructuring because they will suffer more than others from the stabilization, structural adjustment and privatization reform programs. This explains the extreme importance of the social pact, the social safety net and external resource mobilization that make the changes politically and socially more palatable, credible, and acceptable.

and democratically, without fear of retribution, and to reach a required social consensus for a necessary transformation. In addition to the areas mentioned in this paper, Cuba will require many other policies and reforms in order to arrive at the Twenty-first Century with hope and confidence. Our purpose has been to respond to the challenge from courageous dissidents in Cuba (and, hopefully, to the needs of advocates of reform within the government) by trying to contribute to a dialogue and understanding that really are inevitable if the country is to rise from the ashes and prosper in a very competitive international environment.

[1] The views expressed herein are those of the authors and in no way represent the official views of the Inter-American Development Bank. We gratefully acknowledge the comments and suggestions to an earlier version of this paper by José D. Acosta, José F. Alonso, Néstor Enrique Cruz, Margarita Cruz, Emilio Cueto, Armando M. Lago, Eloy R. Mestre, José S. Sorzano, and Clarence Zuvekas.

[2] This term describes the state of the present system as a collapsing meringue referring, rather appropriately, to a light fluffy mixture of sugar and beaten egg whites.

[3] The first mass exodus of Cubans to the United States took place during 1959-63, when some 500,000 refugees fled the Castro regime; the second large wave of emigration took place in 1980 --the Mariel boat-lift-- when approximately 120,000 Cubans entered the U.S.

[4] A former supporter of the U.S. trade embargo on Cuba, Bergner proposed a policy of "flooding" Cuba with U.S. goods and tourists, stating that among other problems its continuation could lead to a large flow of refugees to the United States. See "Let's Stop Isolating Cuba," *The Washington Post*, January 3, 1992. In *Cuba After Communism* (Cambridge: The MIT Press, 1992), Eliana Cardoso and Ann Helwege also call for an immediate end to the trade embargo and travel restrictions.

[5] There have been several analyses of possible outcomes in Cuba, including (1) a policy change by Castro, (2) his departure from the scene not resulting from a conspiracy, (3) a coup d'etat by elements of the armed forces, (4) a popular explosion, and (5) U.S. intervention. In presenting a cogent analysis of possible outcomes in Cuba and implications of each in terms of the effect on the climate for policy-making, Ernesto Betancourt concludes that only (1) and (3) hold realistic possibilities of achieving a transition without significant bloodshed. Thus far, Castro has systematically rejected any meaningful policy change, and Betancourt indicates that "the more Castro delays his departure or setting the machinery for an orderly transfer of power, the more likely that the armed forces will become discredited." See "Revolutionary Propensity, Possible Outcomes and the Political Climate for Cuba's National Reconstruction," in Association for the Study of the Cuban Economy, *Cuba In Transition*, Volume 2 (Miami: Florida International University, 1993), p. 1-27.

[6] Unfortunately since the most recent issue of the *Anuario Estadístico de Cuba* is for 1989, it is not possible to present detailed data on recent trends in the Cuban economy in tabular form, as it would be for most other countries. The analysis that follows is based on official government statements, news reports, and other scholarly research. Almost all macroeconomic figures are state secrets, known to relatively few individuals. This invites corruption by those in the know.

[7] Year the "Rectification Process" began following the Third Congress of the Cuban Communist Party. The Rectification Process meant a reversion to a Stalinist socialism and the rejection of all partial institutional and liberalization reforms of the late 1970's and early 1980's. Three of the most important and popular institutions abolished were the Free Farmers Markets, the bonuses to motivate workers for increases in productivity and quality and reductions in cost, and private enterprise in a wide range of trades and services.

[8] The events in the former Soviet Union in August 1991 started the rollback of the large subsidies provided to Cuba in the form of high prices for its sugar and nickel, the financing of a major trade deficit, and some development loans granted on concessional terms.

[9] G. Zuikow, O. Paviushkina, A. Mijolov and M. Tregubenko, *Informe sobre la economía de Cuba* (Madrid: Fundación Liberal José Martí, 1991) estimated a decline in GSP of 7 percent in 1990 and 20 percent in 1991. Julio Carranza Valdés, "Cuba: Los retos de la economía," *Cuadernos de Nuestra América*, CEA, 1992) reported a drop in GSP of 3.4 percent in 1990, 24 percent in 1991, and 15 percent

in 1992. The authors estimate a further decline of 10-15 percent in 1993.

[10] Newspapers and individual accounts suggest a rise of approximately 300 percent in black market prices between July 1991 and July 1992. See footnote 62 for our definition of "effective" real wages.

[11] Newspapers and individual accounts suggest a rise of approximately 300 percent in black market prices between July 1991 and July 1992.

[12] Jorge F. Pérez-López, "Economic Reform in Cuba: Lessons from Eastern Europe," April 1991, *mimeo.*, Table 1. In 1993 the government acknowledged a budget deficit of \$4.2 billion; hence, assuming a level of revenues similar to that in 1990, this equals a 34 percent deficit.

[13] Dollar remittances from Cuban expatriates has increased social tensions and inequalities. Incentives to work within official non-dollar labor markets have been further undermined, while those to work in informal markets have grown.

[14] Results of country-wide municipal and local elections held December 20, 1992 are very revealing. According to an exit poll conducted by an official agency for use by the leadership whose detailed results were leaked, 30.5 percent of the population --2.4 million persons-- voted "No" to the slate of candidates (expressed by crossing out their ballots) and another 2.1 percent abstained (blank ballots). The percentages in urban areas were higher; in Havana, there were 36.1 percent "No" and 4.9 percent abstentions. The government simply reported that 97.7 percent of eligible voters participated, thus showing support for the system. See *ABC* (Madrid), 17 January 1993, p. 48, 49 and editorial comment, p. 25.

[15] G. Zuikow et al, 1992.

[16] The sugar-for-oil barter agreement signed on November 4, 1992 between Cuba and Russia appears to represent a subsidy to Cuba calculated at approximately US\$150 million for 1993. For a description, see Shaw, Pittman, Potts & Trowbridge, *Free-Market Cuba* (Volume 2, No. 1, Winter 1993), p. 4.

[17] According to Fidel Castro the value of imports dropped from US\$8.1 billion in 1989 to US\$2.2 billion in 1992 and declined further to US\$1.7 billion in 1993.

[18] See La Sociedad Económica, "Cuban Non-Sugar Agriculture: A Background Review of Cuban Citrus, Fisheries, Market Vegetables, Potatoes, Rice, and Field Cops," Bulletin 32, July 30, 1993.

[19] Approximately US\$3 billion of Cuba's convertible currency debt is with Paris Club members, and the remainder is with European and Japanese commercial banks and suppliers. However, information on terms and conditions of the loans is necessary to make a more accurate determination regarding the current debt outstanding.

[20] See Matías F. Travieso-Díaz, *The Wall Street Journal*, January 8, 1993, p. A15.

[21] Policy is made by the self-appointed and perpetual first secretary, who is concurrently president of the republic, chairman of the State Council, chairman of the Council of Ministers, and commander in chief of the armed forces.

[22] In 1991 the government established the "Sistema Único de Vigilancia y Protección" due to increasing robbery in public enterprises. Preference has been given to communist party members for work activities in joint venture enterprises, the tourism sector, and other activities where higher wages are paid, dollars and imported goods are available. Also, substantial sums of hard currency may well

have been deposited abroad in secret accounts by the ruling *nomenklatura*, anticipating the nearing collapse of the regime.

[23] It may be expected that Cuban expatriates will try to rescue their relatives from any bloodshed.

[24] U.S. Congress, National Defense Authorization Act for Fiscal Year 1993, H.R. 5006, Title XVII -- Cuban Democracy Act of 1992.

[25] By a "fundamental" change in government we mean the effective termination of the present totalitarian socialist government --i.e. not merely a cosmetic change in the leadership-- and its replacement by some form of provisional or coalition government that has expressed commitment to a democratic process.

[26] The Aspen Institute, Inter-American Dialogue, "Cuba in the Americas: Reciprocal Challenges," Washington, D.C., October 1992, p. 8.

[27] On July 27, 1993 a bill (H.R.2758) was introduced by 17 congressmen of both parties, with the short title of "Free and Independent Cuba Assistance Act of 1993," calling on the U.S. Government to provide financial, educational and humanitarian assistance to Cuba in the event a transitional government pledged to democracy assumes power. However, the first draft of this bill appears to unnecessarily restrict the President in determining what constitutes a "transitional government."

[28] A recent statement to this effect was by Assistant Secretary for Inter-American Affairs Arthur F. Watson in a speech on October 26, 1993 before the Cuban American National Foundation: "The United States remains dedicated to adequate compensation for these losses by the government of Cuba at the earliest possible opportunity, as called for in the Foreign Assistance Act of 1961 and reinforced by the Cuban Democracy Act."

[29] For example, 22 U.S.C. 287r instructs the United States Executive Director to the Inter-American Development Bank to vote against any loan or other utilization of funds of the Bank for the benefit of any country which has expropriated property owned by United States nationals, unless prompt, adequate and effective compensation has been made, good faith negotiations are in progress, or the matter is in international arbitration. Similarly 22 U.S.C. 284j provides identical instructions to the United States Executive Directors of the World Bank and IDA, while 22 U.S.C. 286e-11 requires the Secretary of the Treasury to instruct the United States Executive Director to the International Monetary Fund "to actively oppose any facility involving the use of Fund credit by any Communist dictatorship" unless the Secretary certifies that extension of credit would, among others, advance "market-oriented forces in that country."

[30] Matías Travieso-Díaz and Stephan M. Bleisteiner, "Some Lessons for Cuba from the Legal Changes in Eastern Europe," April 1993, p. 19.

[31] To use some well-known examples, poet Jorge Vals could make a claim for damages resulting from 22 years of unjust imprisonment; the mother of student leader Pedro Luis Boitel could likewise claim damages resulting from the wrongful death of her son while unjustly incarcerated; human rights activist and poet María Elena Cruz Varela could bring suit against the government for assault and unjust incarceration. Well-documented examples of state-sponsored mistreatment and torture are detailed in Charles J. Brown and Armando M. Lago, *The Politics of Psychiatry in Revolutionary Cuba* (New Jersey: Transactions Press, 1991).

[32] It is interesting to note that Article 26 of the 1976 Constitution provides that "any person suffering damages or loss income or value unduly caused by public officials or government agents during the performance of their duties has the right to claim and obtain the corresponding reparation or

indemnification as provided by law."

[33] Title V was added by Public Law 88-666 (78 Stat. 1110), approved October 16, 1964.

[34] See Geneva Initiative on Psychiatry, *Psychiatry Under Tyranny: An Assessment of the Political Abuse of Romanian Psychiatry During the Ceausescu Years*, Amsterdam, 1992, p. 14.

[35] See FCSC Decision CU-0249, American Cast Iron Pipe Company.

[36] Ralph J. Galliano, "The Resolution of U.S. Cuba Claims: Toward a Democratic, Free Market, Post-Castro Cuba," Washington, D.C., the Selous Foundation, May 20, 1993, p. 5, 6.

[37] An interesting paper in support of restitution is Robert E. Freer, Jr., "The Significance of Restitution in the Economic Recovery of Cuba," paper prepared for the Cuban American National Foundation's Blue Ribbon Committee on the Economic Reconstruction of Cuba, May 25, 1993. The author indicates that he represents certified claimants who seek the return of their property. The National Association of Sugar Mill Owners of Cuba (Asociación Nacional de Hacendados de Cuba, Inc.) is also very active in this regard. A.R.M. Ritter, while acknowledging that it has "only a limited role to play," does not rule out restitution; see "Financial Aspects of Normalizing Cuba's International Relations: The Debt and Compensation Issues," *Cuba In Transition*, Florida International University, 1993.

[38] Freer recognizes that a process of restitution "will, to some degree, inhibit the rapid privatization of property. Forcing claims into the courts could well cause a lengthy lag between the claim and the actual vindication of title." Freer, *op. cit.*, p. 12.

[39] The FCSC certified corporate awards totalling US\$1.6 billion at the time of confiscation, most of which took place in July/August 1960. As a matter of interest, official U.S. Government statistics place the total value of U.S. investment in Cuba in 1960 at US\$956 million. (See *Survey of Current Business*, August 1961, Table 3, p. 22, 23.) While the latter figure might represent book value, the discrepancy serves to highlight the need for careful review of the FCSC's awards.

40 Such an inventory would represent a case of Coke for every four persons in Cuba in 1960, an unlikely possibility. The FCSC originally felt that an estimate of 500,000 cases would be more reasonable.

[41] North American Sugar Industries alone owned a tract of land of approximately 42 miles by 30 miles (3,300 square kilometers) and three sugar mills, including two of Cuba's largest.

[42] See Jorge A. Sanguinety, "Some Issues About Expropriation Claims In Cuba," *ASCE Newsletter*, Spring Issue, May 1993, p. 10, 11.

[43] According to recent documents, between 80 and 90 percent of dwellings in Cuba are at present privately owned, many with titles issued by the Castro government. Our policy suggestion includes recognition of the validity of these titles to all "peaceful occupants," that is, excluding properties occupied by certain classes of persons, such as the *nomenklatura*, those whose titles were issued within twelve months of a change in government, etc.

[44] At present Cuba has regular armed forces of approximately 300,000 (including 6,000 Ministry of the Interior troops, 35,000 internal security troops, and a 20,000-man special police battalion) plus 135,000 army reserves, in addition to militia, rapid reaction battalions and other non-regular forces. (See: Defense Intelligence Agency, *Handbook on the Cuban Armed Forces*, Defense Research Reference Series, DDB-2680-62-86, Washington, D.C., 1986, p. I-12.) This may be compared with Argentina, a country with a land mass 25 times the size of Cuba's bordering on five other countries, with three times Cuba's

population, and has a total armed forces of some 20,000.

[45] In "Red Army Scare," (*Forbes*, March 1, 1993, p. 68-69), Paul Klebnikov refers to an interesting program underway in Russia that offers four-month courses in marketing and business administration to former Soviet Army officers; apparently, veterans of the Afghan war --*Afghantsy*-- because of their work ethic and discipline, are an emerging managerial and entrepreneurial class. A similar approach might be taken with Angola veterans in the Cuban army.

[46] Population projections place Cuba's population age 6 to 17 years at approximately 230,000 for the 1990 to 1995 period. Fertility rates had been decreasing throughout the 1960's and 1970's, but increased again toward the end of the 1980's.

[47] The OAS proposed the holding of elections, a general amnesty for those taking part in the fighting, the surrender of unauthorized arms, and the convening of a constitutional assembly within six months of an elected government taking office. The OAS mediation effort also persuaded rival Dominican groups to agree on an interim president. Finally, a special fund was set up to provide food and medicine relief to the population. See, for example, Indar Jit Rikhye, *The Theory and Practice of Peacekeeping* (New York: Published for the International Peace Academy by St. Martin's Press, 1984).

[48] If the situation in Cuba deteriorates much further, rather than waiting for a popular explosion and ensuing bloodshed, the Secretary General of the UN might act on the basis of the request for assistance from the international community contained in the "Declaration of Cuban Intellectuals" of May 20, 1991. See Of Human Rights, *Dossier: El caso de María Elena Cruz Varela* (Washington, D.C., May 1992), Document No.3, p. 4-5. A team including some of the persons mentioned might be dispatched to Cuba to attempt to convince the current leadership to allow a rapid and orderly transfer of power for the good of the country and to avoid bloodshed.

[49] The configuration of the CNR or provisional government should be such that Cuban expatriates are a small, although important, minority. Excluding expatriates will not result in reconciliation.

[50] Vito Tanzi, "Introduction," in Tanzi (ed.), *Fiscal Policies in Economies in Transition* (Washington, D.C.: International Monetary Fund, 1993), p. 2.

[51] Inertial inflation can be defined as inflation today being approximately equal to what it was yesterday. Inertial elements can cause inflation to rise sharply, i.e. huge changes in relative prices are likely to force the price level upwards and the price maximizing behavior of the state enterprises will tend to make prices soar. If there are inertial elements, some kind of incomes policy is indispensable to eliminate them.

[52] The significant scope and depth of some recommended policies and reforms may require their ratification by a duly elected constitutional government.

[53] A first order of business should be the preparation of a list of data requirements, with priorities for obtaining the information.

[54] Simultaneously, a comprehensive system of reforms should grant substantial economic autonomy and legal status to state enterprises.

[55] The reaction of large enterprises to price liberalization will be quite natural. Every enterprise will try to raise its price as much as possible and cut production. Allowing monopolistic firms the freedom to set their own prices runs the risk of severe monopolistic distortions, which cannot be rectified by entry of new firms until factor markets are developed. There will be difficulties in buying or leasing land, in

obtaining inputs from state firms, and in securing intellectual property rights. When a monopoly is combined with powerful and aggressive unions, inflationary wage increases can also occur, creating two significant problems: (1) a large price increase can lead to a large wage increase in the monopolized sector, which could have administrative or transmission effects to the whole economy; and (2) disguised monopoly profits can slow down the process by which high profits attract entry and thus competition.

[56] Ronald McKinnon and Sebastián Edwards make a strong case for this sequence.

[57] This policy recommendation is based on the experiences of Poland (1990-1991), Yugoslavia (1990-1991) and Nicaragua (1991-1993) and the initial proposals made by Jeffrey Sachs for Peru and Russia. See Carlos Paredes and Jeffrey D. Sachs (editors), *Peru's Path to Recovery* (Washington, D.C.: The Brookings Institution, 1991), p. 130 and Graham Allison and Grigory Yarlinsky, *Window of Opportunity* (New York: Pantheon Books, 1991), p. 68. Rudiger Dornbusch has also favored a policy of initial exchange rate overshooting, moving later, after some basic stabilization has been achieved, to a crawling peg.

[58] For example, Cuban citizens could receive money from abroad but would not be able to acquire foreign exchange for non-business travel for, say, two years. In Czechoslovakia citizens were permitted to acquire up to US\$250 for foreign travel.

[59] This was done in Colombia by President Gaviria in 1991 --the so-called "revolcón"-- because there was a marked delay in imports which was increasing inflationary pressures at a time of expanding international reserves. One risk of gradualism is that economic agents will not recognize the extent to which it is needed, and the well-intentioned gradualism might be considered as procrastination. Announcing the non-negotiable schedule for tariff reductions should reduce this risk.

[60] Similarly, there is a large stock/flow disequilibrium between foreign obligations and exports as reflected by a high debt/export ratio.

[61] An alternative, albeit less desirable because it would be considered as confiscatory, would be the introduction of a new currency (1 new peso= 3 or 4 old pesos). The price level adjustment operates through increasing the denominator to reduce real monetary balances, while the new peso operates decreasing the numerator. Another alternative is a forced conversion of currency into bonds; however, this means that the government would start stabilization with a high ratio of interest-paying debt to GNP.

[62] An alternative is to allow wages to rise by only a fraction of inflation and impose heavy penalty taxes on the wage bill of enterprises that exceed the limit. "Effective" real wages (nominal wages adjusted by a weighted average of official prices and black market prices) in Cuba are much lower than "apparent" real wages (nominal wages adjusted by the official price index). As soon as prices are liberalized and the black market disappear, "apparent" real wages will decline and reach the "effective" real wage level. This will appear to be a decrease in real wages but it is rather the elimination of fictitious official prices.

[63] A quality control program including inspection and certification should be encouraged in order to increase the quality of exports of some products (e.g. citrus fruits) and should be financed by user charges.

[64] It is interesting to note that private capital remittances to El Salvador and to the Dominican Republic averaged approximately \$300 and \$315 million per year respectively during 1989-91, and reportedly reached \$700 million for El Salvador in 1992.

[65] See Chapter 5 and the Appendix of Ernest H. Preeg, *Cuba and the New Caribbean Economic Order*

(Washington, D.C.: Center for Strategic and International Studies, 1993).

[66] Matías F. Travieso-Díaz and Stephen M. Bleisteiner have outlined nine basic and indispensable elements of legal and institutional reforms required to have a working market economy: constitutional law changes, laws for the re-institution of private property and the privatization of state-owned enterprises, laws governing the creation and operation of business enterprises, general commercial law, law providing tax investment incentives, antitrust and intellectual property protection laws, laws regulating the financial system, bankruptcy law, and labor law and social welfare legislation. See Matías F. Travieso-Díaz and Stephen M. Bleisteiner, *op. cit.*

[67] Any dispute about a contract should be resolved by judges who have no stake in the dispute and whose jobs do not depend upon the pleasure of the current political leadership. Also alternative conflict solution measures should be created.

[68] In Cuba, military industries consist mainly of machine-tool and repair facilities.