Economic Policy in Cuba's Transition to a Market Economy: Lessons from the Russian Experience

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When the movement of economic reform started in Eastern Europe just a few years ago, policy makers were in uncharted territory: there were no historical precedents to guide them in the task of transforming a centrally planned economy into one based primarily on the operation of markets. When the political conditions for such a transformation emerge, Cuba's reformists will have at least one advantage: they will be able to draw lessons from the experience of more than twenty countries. They will have precedents, examples of what to do and what not to do in order to make the transition to a market economy irreversible and successful, and to minimize the pain that it will inevitably involve.

There are, of course, important precedents in Central and Eastern Europe. But I will argue that the most relevant precedent for Cuba is not Poland or Hungary, where elements of a market economy had existed for some time, or even Estonia or Latvia, where the passion for national independence fueled a quasi-unanimous and irresistible urge for change. For a number of reasons, the most relevant example for Cuba is Russia.

In some respects, no situation can be quite as tragic and complex as the one inherited by the Russian reformists in the fall of 1991. Cuba, for example, will not have to deal with the legacy of a disintegrated empire and the difficult task of restructuring monetary and trade relations with other former Soviet republics, or with threats of secession even within the national territory. Unlike Russia, Cuba will not have to deal with a gigantic military-industrial complex that continues to produce things that nobody wants to buy, but that cannot be eliminated overnight for fear of converting entire cities and regions into economic black holes.

Another important difference is that Cuba *already* has suffered some of the shocks that Russia had to experience during the Yeltsin period. In effect, Cuba has *already adjusted* to the collapse of trade with the CMEA; to a surge in the cost of energy; to an acute shortage of foreign exchange and of imported materials and parts; and to the cost of repatriating large numbers of soldiers from distant places were they are unwelcome. This, of course, does not lessen the cost of the adjustment that has been paid, and continues to be paid by the Cuban people. (Indeed, the recently leaked official report on *"The Global Overview of the Economy"* estimates that Cuba's net material product may have plunged in 1992 to only 35 percent of its' average level in 1986-89.) What it does mean is that the *political* cost has been, and is being, borne by the present Cuban government; the game of blaming the reformists for the problems created by the old regime will be more difficult to play in Cuba than it has been in Russia.

In spite of these caveats, pre-reform Russia is, in my view, the right "model" for Cuba in many essential ways: in terms of the extreme character of economic centralization; in terms of the absence of private property; of the degree of bureaucratization and control of all aspects of economic life; of the extent to which resource allocation is distorted by an arbitrary structure of relative prices; because of the severity of shortages; and, correspondingly, because of the extent to which inflation has been repressed by controlling the absolute price level at an artificially low level. Finally, the legacy of communist power in Cuba, like in Russia, will be a nation with very few assets but huge liabilities, including a massive external debt and, most probably, severe environmental damage.

The Russian experience with reform is now a year and a half old. Some of the measures adopted by the reformist government have been, in the light of experience, eminently wise and successful. But some of the things that were done ‹as well as some of the things that were *not* done‹ have seriously complicated or delayed the process of reform. What, then, are the key lessons that we have learned from the Russian experience during the past 18 months ‹the lessons that future reformists in Cuba will need to bear in mind when the time for change comes?

From a long list, I have selected **8 principal lessons**:

(1) From the outset President Yeltsin **appointed a highly professional and fully committed team of reformists** headed by Yegor Gaidar to push ahead with economic reform, and he gave that team all the political support he was able to provide under the circumstances. This is essential: the task of economic reform must be given to people who know their business, who are trusted by the political leadership, and can be shielded from undue political pressure for a reasonable time period.

(2) The economic team that Yeltsin appointed to key cabinet positions, for all its remarkable qualities, probably **tried to do too much by itself, without relying on the existing bureaucracy**. As a result, the middle and lower levels of the administration too often lacked a sense of direction, did not understand what the government was trying to achieve, and suffered from a sense of isolation. Orders frequently were not carried out, or they were carried out in a half-hearted way, and often without a proper understanding of what had to be done. This mistake must be avoided in Cuba. To be sure, it will not be possible to bring on board some members of the bureaucracy staunchly committed to the old regime. But many others will probably serve well if an effort is made to explain the objectives of the reform process and to make them feel that they are an integral part of the effort.

(3) In January 1992 the Russian government took a step of historical importance by enacting a **radical liberalization of prices**. Cuba will have no alternative but to follow Russia's example: for several reasons, a gradualist alternative to immediate and full price liberalization will not work and could even turn into disaster. *First*, the current price structure in Cuba is so hopelessly distorted that the authorities will have no guide as to which prices will have to be administratively raised, and by how much, in order to move gradually to a more rational structure of relative prices. *Second*, the new Cuban government will inherit a severe fiscal problem and will not be able to pay the subsidies required to sustain price controls. *Third,* as soon as the process of liberalization begins, the population will hedge against future price increases by buying in advance and storing consumer goods in their kitchens and closets, and enterprise managers will do the same with producer goods and raw materials. As a result, goods will simply disappear from markets, as they did in Russia at the end of 1991. As Yegor Gaidar once observed: the choice in January 1992 was between sweeping price liberalization and imposing martial law.

(4) Perhaps the only serious mistake the Russian government made in January 1992 was to exclude energy from the process of price liberalization. The gradualist approach that was adopted with respect to energy gave time to those who oppose the abolition of subsidies to organize, and today the domestic oil price in Russia remains at about one-third of the world price, implying the continuation of expensive budgetary subsidies, and maintaining a highly inefficient and wasteful pattern of energy use by both enterprises and households, with adverse implications for the balance of payments. Cuba will not be able to afford either the budgetary subsidies or the foreign exchange costs of excessive oil imports. And, unlike Russia, Cuba does not have a cold climate that makes the elimination of subsidies on residential heating extraordinarily difficult from a political point of view. **Therefore, Cuba should liberalize energy prices fully, and at an early stage**.

(5) From the very beginning, Yeltsin and his government took the issue of **privatization** most seriously. They created a Committee for State Property to handle the privatization process and appointed one of their best, Deputy Prime Minister Anatoly Chubais, to head the effort. For a variety of reasons, however, the process was a little slow to get started, although it is now moving quite rapidly. Cuba should not, and

cannot, afford the luxury of a lengthy and protracted privatization process. It should **quickly set up a small-business privatization agency, and invest it with authority to privatize immediately small scale agriculture and small and medium-size businesses in the services area**. This would achieve two goals: (i) small-scale privatization, combined with price decontrol, would provide immediate incentives to produce and to invest in important sectors of the economy ‹and we know from Cuba's own experience that the supply response of domestic small-scale agriculture can be rapid and powerful; (ii) small-scale privatization, combined with granting property of apartments to their tenants for a moderate fee, would create a large constituency of citizens with a strong personal interest in supporting economic reform and democracy.

(6) In the case of large industrial and mining enterprises, the new Cuban government should do immediately what the Russian government has been considering only recently: set up an autonomous Agency for State Property funded by the government (and, hopefully, with substantial financial contributions and/or technical assistance from international financial institutions and friendly foreign governments). That agency should make an inventory of the relevant enterprises and decide which ones can be quickly privatized, which ones are hopelessly inefficient and will have to be closed down, and if so when, and which ones are potentially viable but require **temporary** support from the government. By law, any support should come directly from the budget and **not** from the National Bank of Cuba, **should decline over time, be strictly conditional upon effective restructuring, and strictly limited in the aggregate so as to be consistent with the overall aims of macroeconomic policy**.

(7) Perhaps the most important lesson of the Russian experience is that the **reformist government cannot, and should not, tolerate high inflation**. To be sure, price liberalization in Cuba will involve a jump in the price level, perhaps a very large one, as was the case of Russia. In fact this jump will be required to do away once and for all with what is likely to be a huge monetary overhang. But the experience of Russia in the first half of 1992 (and also that of several Eastern European and Baltic countries) demonstrates that this adjustment in the price *level* need not evolve into a lasting inflationary process *provided that* the central bank keeps the supply of money and credit under control. What went wrong in Russia is that in July 1992 the Supreme Soviet fired Central Bank of Russia Chairman Grygory Matjukhin because he was denying credit to enterprise managers and sectoral lobbyists who thought they were entitled to official financing on the basis of their political acquaintances. The leadership of the Central Bank of Russia changed and monetary policy became highly expansionary. The results are now clear: the monthly rate of inflation increased from less than 8 percent in June-July 1992 to an average of 22 percent (or more than 1000 percent at an annual rate) in January-May 1993; the ruble plunged in foreign exchange markets from 125 per US$ in June 1992 to more than 1000 per US$ at present; and capital flight in 1992 was anywhere between $6 and $14 billion, as Russian interest rates have become sharply negative in real terms.

The stability of the peso has to be unambiguously recognized as the overriding objective of the National Bank of Cuba. This means that **the Bank must be independent from the Government, but also from all other political institutions including, in particular the Congress, if there is one**. The head of the National Bank and the member of its governing board should be appointed on the basis of outstanding qualities of professionalism, honesty and dedication to financial stability; they should work closely with the government's economic team, particularly in the early stages of the reform; but they should have full authority to determine the rate of credit expansion of the central bank and the level of its lending rate. Most importantly, they should be in a position to refuse extending subsidized credits to specific enterprises, sectors and jurisdictions, *even* if the borrower carries a personal letter from a cabinet minister.

(8) The Russian experience strongly suggests that the reformist government should deal expeditiously in the event of a buildup of **inter-enterprise arrears**. Specifically, the government and the National Bank

of Cuba should make it clear that they will not, under any circumstances, extend credit to finance inter-enterprise arrears. The creditor enterprises should be told that if they wish to extend credit to other enterprises they will do so at their own risk. And the debtor enterprises should be warned that they will not be bailed out, and that if they are unable to repay their debts within a reasonable period they will be declared bankrupt. This, of course, means that the legal framework for bankruptcy must be put in place as a matter of priority.

Finally, Cuba, like Russia, will have to deal with a military establishment that is very large relative to the population and very expensive in budgetary terms. No doubt, procurement will have to be cut sharply. But soldiers will have to be paid until they can be reabsorbed into the civilian economy. To do this without imposing a crushing tax burden on enterprises and individuals will mean strict austerity with regard to public expenditure for some time, patience on the part of Cuba's creditors, and support from its friends and neighbors.