The Case for an Independent Central Bank

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The Central Bank of Cuba, *Banco Nacional de Cuba* (BNC), was created in 1948 and commenced operations in 1950. This institution was modeled after the U.S. Federal Reserve Bank system. BNC functioned as the monetary authority for a brief perio d until the onslaught of the Castro regime and the island economy's transformation to a centrally planned communist system. Due to the nature of economic organization under a communist state, the banking system was disbanded and the BNC assumed the role of central bank and commercial banking system. The role of credit allocation through financial intermediation was eliminated since the state became, in effect, a single corporation. Retail banking services were limited to basic savings accounts offered through nationwide branches of BNC. International banking was also centralized under the control of the BNC or the *Banco Financiero Internacional*.

The rebuilding of Cuba's financial system will need to begin with the reinstatement of BNC's original charter as the nation's central bank. In fact, it has been suggested that the name be changed to "Banco Central de Cuba" in order to reflect its tr ue purpose. Some academic economists have suggested that the ideal situation for a post-Castro Cuba would be to eliminate the central bank and assume the dollar as the effective currency. We do not support such a proposal in view of the very negative re sults experienced by a few countries that have attempted a similar approach. In addition, we recognize that Cuba, as an independent country, will not subsume its monetary system to that of another country. In effect, the rebuilding of the Cuban economy s hould be based on prudent economic management implemented through a credible monetary authority under the auspices of the BC.

The traditional functions of a central bank have been associated with the management of monetary policy through regulation of the monetary aggregates, and to a limited extent, with the supervision of the financial system. Even though the basic stru cture is the same, central banks differ in their institutional framework across all countries, whether industrialized or developing nations. The three principal instruments of monetary policy have been the following:

1. **Reserve requirements**. Under the fractional reserve system the central bank regulates the amount of liquidity in the system which at the same time should be compatible with an appropriate level of reserves necessary for the stability of the system.

2. **Rediscount facilities.** If additional liquidity is needed over an above what is provided through the other instruments, the central bank can extend credit to financial intermediaries in the form of rediscounts of eligible instruments. The re discount facility, or window, is also available as a source of funds for institutions that may be experiencing liquidity problems.

3. **Open market operations.** Through the purchase or sale of financial instruments, principally government securities, the central bank can control the amount of funds in the system. This instrument is easier to apply and has a more immediate ef fect on liquidity than the others. However, the capacity to use open market operations as an instrument to control the monetary aggregates is dependent on the depth and degree of development of the domestic money and capital markets.

Since foreign assets represent one of the components of the monetary aggregates, the central bank is the guardian of a country's international reserves, and acts as the regulator of the foreign exchange market.

We recommend that the BC's organic law be revised in order to assure its independence as a monetary authority. In this regard the experience of Latin American countries, which exhibit many similarities to Cuba in terms of the economic development pro cess, can offer some important lessons on the structuring of Cuba's monetary system.

Historically Latin American central banks have played the dual role of monetary authority and commercial banker while under the direct supervision of the central government. Typically, the central bank was established as a subordinate agency to the Ministry of Finance, which in turn was charged with the management of fiscal policy. Because of this arrangement, the central bank was required to finance government deficits without consideration of the impact such financing would have on the monetary ag gregates. We strongly recommend that BC be given autonomy to execute its monetary policy objectives.

BC should not be permitted to use the rediscount facility as an instrument to channel credit to the financial system. In Latin America, many central banks made extensive use of the rediscount facility to finance investment and working capital needs o f private as well as public sector companies, at times using subsidized interest rates. A revamped BC should not extend credit to the economy, but only use the rediscount window as an instrument of monetary policy, or as temporary support for banks exper iencing liquidity problems. We think there is a role for the government in financing development, but this could be arranged under a properly structured development bank.
Not only should the central bank avoid interfering with the banking system's credit allocation mechanism, but it should not intervene in the setting of interest rates. These should be market determined. Although, during the transition period, when there is likely to be a severe liquidity constraint, the BC might prefer to set interest rates on a very selective basis, with the understanding that within a specified timetable rates would become market determined.

Initially, the BC will have very limited recourse to open market operations. The rebuilding of Cuba's financial system will likely mean the establishment of a safe and sound banking system before moving on to the development of a capital market. Th e latter will not emerge until there is confidence in the stability of the economy and the financial system. Thus the process of introducing an open market operations capability may take years. Nevertheless, this should be identified as a policy objecti ve with specific deadlines in terms of passage of legislation and introduction of appropriate financial instruments.

In countries with unstable economies, such as would be the case in a post-Castro Cuba, the management of the foreign exchange markets is tightly controlled by the central bank. The central bank becomes in effect the official market, and regulates th e rate of exchange between the domestic and foreign currencies. As experience has amply demonstrated, the policies of managed exchange rates under severely restrictive foreign exchange regulations have sprouted parallel and black markets which eventually undermined the official market. In principle, the exchange rate should be market-determined. We think the BC should act as regulator of the foreign exchange market with limited intervention. A precondition for this arrangement should be the establishm ent of a suitable international reserves position that can serve as a stabilization fund for temporary imbalances in the market. We do not advise liberalization of the Cuban peso market from the start, but rather, a policy of pegged exchange rates until some sense of normalcy can be achieved in the economy. The shock of a massive devaluation in an economy that lacks efficient domestic markets could inflict severe hardship on the citizens, while failing to produce the desired economic responses.

One of the initial goals of the BC should be to seek technical advice and assistance from the International Monetary Fund (IMF) on central banking operations. If Cuba decides to join the IMF, it will become eligible for this type of support. A revi talized BC will need to evolve during a transition period. Initially it is likely that BC will continue to act as a financial intermediary until commercial banks assume that role. The success of a new monetary system will be critically dependent on a re alistic timetable for achieving the transition from the rubble of the present regime, to an efficient and reliable apparatus of monetary policy.

Conditions for a Successful Transition

In the transition period after the change in regime, it will take some time to transform the present all-embracing domestic banking functions of the Banco Nacional de Cuba into a modern Central Bank and a private banking system. The speed and depth of this reform will depend on the political conditions ruling in post-Castro Cuba, and the probable consultation of the Cuban people in terms of elected officials for constitutional reform and for members of the legislative, executive and judicial branche s of government.

First, the BC should emit by fiat the medium of exchange, unit of account and store of value that would in all probability be the Cuban peso, as legal tender in the Republic. In combination with the private banking system, it would create credits an d deposits of different kinds that, together with the currency, would constitute the supply of money in Cuba.

Second, it would conduct monetary policy by making money more or less easily available in accordance with the needs of seasonal variations, the economic cycle and growth trends and the control of inflation, the latter being foremost. It would also s eek to introduce financial instruments that may eventually serve as the basis for a more efficient management of open market operations.

Third, as the principal agent of the government in international finance, it should be the keeper of international reserves, the holder of the Special Drawing Rights (SDRs) issued by the International Monetary Fund, and the regulator of the foreign e xchange market mechanism chosen in the transition period. Exchange rate policy should range from passive, when the rate of exchange is determined by the market, to managed, when there are limited and selective interventions. But in all cases, the BC sho uld consider the sterilization of important surges or ebbs in the excess supply or demand of foreign exchange. The institution should also play a key role in setting the parity with regard to the U.S. dollar.

Fourth, the Central Bank has to ensure the soundness and rapidity of the banking payments system. Credits and debits in the system should be matched accurately and quickly, and liquidity problems and banking failures should be speedily alleviated an d contained.

Fifth, the BC should provide the clearing services for checks, with special attention given to large transactions.

Sixth, the Central Bank would be the banking agent for the Cuban government, closely related to the Ministry of Finance. It is for this reason primarily that the BC should be an independent and autonomous body from early times in the transition peri od. The principal danger otherwise would be the accommodation through the easy purchase of the public debt that would discredit the central banking functions in Cuba, as well as promote large fiscal deficits.

It is to be understood that the process of developing a market-oriented banking system will require important structural changes from the present Cuban system. This should be a gradual process with a clearly defined timetable for development during the transition period. Issues like the independence of the BC and the supervision of the banking system must be decided democratically.