Monetary Dualism as an Instrument Towards a Market Economy: The Cuban Case

Jorge A. Sanguinetty, Development Technologies, Inc.[1]

Introduction

Cuba's economy continues to deteriorate at a fast rate following the unexpected disappearance of Soviet subsidies. Real GDP is reported to have fallen 70 per cent or more since 1989, transportation and manufacturing activities are reduced to a trickle, and the 1992-1993 sugar harvest was a dismal 4.8 million tons, 37 per cent below the 1990-1991 harvest. Rivero (1992, p. 128) estimates that sugar earnings fell 73 per cent, from US$3.6 billion in 1991 to US$978 million in 1992, The depth and characteristics of the crisis have also been described by Alonso and Rathbone (1992), and Sanguinetty (1992, 1993), among others.

The most damaging effect of the current crisis, however, is not the simple contraction of economic activity, but an actual disintegration of the economic structure of the country, including its productive capacities, its distribution networks, and its management systems. There are strong indications that the economy is suffering from heavy disinvestment as the scarce resources available do not seem to be sufficient to cover the most basic needs of the population. The deeper this process gets, the more difficult will be the economic recovery of Cuba.

Even though Castro is trying to save his socialist regime by adopting certain liberalization measures -- which resemble more of Lenin's New Economic Policy (NEP) of the 1920s than anything else-- the end result can be expected to be an economy with most of its fixed capital stock in shambles, no inventories, and no financial reserves. Cuba's credit is among the worst in the world, a situation complicated by a staggering external debt.

Under these conditions, Cuba's economic recovery will require a major reconstruction effort, well beyond a reactivation of current capacities and injections of fresh funds. Therefore, the speed of the country's economic reconstruction depends on the level of investment activity that can be achieved in Cuba, which at the same time depends on the volume of capital inflows that can be attracted to the country. Although export earnings and remittances could be important sources of funds, they would barely cover current needs.

As a result, the maximization of investments and capital inflows should be among a reconstruction government's top priorities.[2] As a complement to this policy, another top government priority should be to facilitate to the maximum state possible the development of an export sector. Given the size of Cuban markets and the state of current technologies and economies of scale, Cuba's growth prospects depend on its ability to export. The current crisis has created conditions that, *ceteris paribus*, could constitute strong investment incentives in many sectors. For instance, as the stock of capital depreciates while the population continues growing, the aggregate marginal productivity of capital increases. This process is reinforced if the reports about the high quality of the Cuban labor force that resulted from heavy investments in human capital are correct, as expected. A high marginal productivity of capital translates into the possibility of achieving high rates of return to investments if other conditions hold. At the same time, the impoverishment of Cuban labor should be a strong incentive to work hard an recover some of the losses generated by the current crisis and before. The reports about the level of salaries being currently paid in the tourist sector suggest that Cuban labor, in efficiency units, could be inexpensive and highly competitive for export industries.

Nevertheless, these potential incentives for new investments could be more than neutralized by the many obstacles that exist today to competitive ventures in a free market economy.[3] Besides the traditional legacy of central planning insufficiencies (unreliability of supplies, no financial services, deplorable communications, no contractual security, ubiquitous and officious government intervention), the specific consequences of the current crisis, especially a high level of public disorder (unknown in the country until recently), widespread malnutrition, extreme fiscal disequilibrium, and a general atmosphere of instability can be expected to reduce, perhaps eliminate the incentives for new investments.

A transition government will face major obstacles in trying to create a favorable investment climate while at the same time trying to correct major fiscal and monetary disequilibria. For instance, as the level of real GDP continues its free fall, government revenues are not sufficient to sustain the lavish social programs (see Mesa-Lago, 1993), plus the sizable volume of the armed and security forces. If the population do not understand the reasons for realigning government expenditures with the fiscal reality of the country, widespread protests and political unrest will follow any reasonable fiscal policy. It would be unwise to forget that social programs were the trademark of Cuban socialism and the fact that even experts today still label them as revolutionary successes indicate the low level of public understanding about what make them affordable; the forever gone soviet subsidies. Besides, the unemployment generated in the short run by such a policy can also fuel political unrest contributing to keep investments away.

Investments are not only critical to rebuild the economic capacities of the country, but to generate the employment necessary to a major structural adjustment of the economy. Moreover, investments are not only necessary to rebuild productive capacities to satisfy the internal demand for goods that can be produced domestically but also to develop a strong export sector. Developing export competitiveness is therefore critical and should be another of the top priorities in the macroeconomic policy of the transition government. In this regard the transition government should avoid overvaluation of the exchange rate and labor legislation constraining wage flexibility in the Cuban economy.

Price stabilization, on the other hand, is indispensable for a sound investment promotion policy, since the uncertainties of inflation would add significantly to investment risks, already expected to be high in a Cuban transition context. Short-run stabilization by itself, however, may not be politically feasible given the volume of the labor force affected by the adjustments and would contribute to a climate of social and political unrest contrary to the goal of bringing investments in a massive scale. How, then, can the transition government achieve macroeconomic stability and promote investment in a massive scale at the same time? Exchange rate instability, on the other hand, increase the uncertainty of business decisions at the firm level (Krugman, 1990, p. 76), but fixed exchange rates may not feasible in Cuba for some time as the economy adjusts to a free market system. What kind of system could combine the advantages of a fixed rate system with perfect and credible mobility of capital? What kind of monetary system could provide both the advantages of fixed exchange rates and the advantages of managed or floating rates (avoiding over valuation) at the same time?

The answer to the above questions lies in establishing a dual monetary system with both the peso and the US dollar becoming unlimited legal tender. Moreno (1992) first offered the idea of a monetary system for Cuba similar to Panama's as an instrument to facilitate Cuba's transition to a market economy. Sanguinetty (1993) adapted Moreno's ideas to a dual monetary system, which is discussed in this paper in more detail.[4] The proposal is relatively simple; allow both currencies to circulate as unlimited legal tender in Cuba with a totally free exchange mechanism between the peso and the dollar. This in fact will serve to separate the dismal economic system inherited from central planning (with all its problems), from the economic system to be created. The old system, associated with the peso, requires severe adjustments that should not be mixed or confused with the measures necessary to attract external resources for investments. Monetary dualism will allow to design and implement economic policies that have different objectives without interfering each other. But before we discuss this proposal in more detail, section II of this paper presents some relevant background material about historical antecedents in

Cuba and also Panama's experience with its unique system. Section III presents the proposal in more detail and a discussion of several implications. Sections IV and V are brief reviews of some disadvantages and advantages of the proposed system, while section VI contains some concluding remarks.

I. Background

A. Monetary Dualism in Cuban History

The Cuban peso was born in 1915 when the US dollar was already legal tender (Pérez and Pazos, 1940, p.27; Wallich, 1950). Monetary dualism existed legally in Cuba until 1950, upon the creation of the Cuban Central Bank (Banco Nacional de Cuba), and it was surprisingly revived in June of 1993 after the Cuban government surrendered to the predominance of the US dollar in the black market, in the presence of chronic scarcity of goods and a *de facto* debasement of the peso.

Although the US dollar never disappeared completely from black market transactions after 1959, its holding by Cuban citizens was so tenaciously persecuted and sternly punished by the Castro administration throughout the last three decades, that it was rarely seen in such dealings. But the increasing importance of the tourist industry as a source of hard currency and the government's efforts to attract foreign tourists and investors in this and in other sectors of the economy, made the presence of the dollar a standard feature of the economy. Monetary dualism was back in Cuba, for quite different reasons than those proposed earlier by Moreno (1992) and Sanguinetty (1993).

This time, however, the development of the dollar-peso dualism followed a different path, but with essentially the same causes; the need to finance government expenditures. In 1914 the coinage of the Cuban peso generated a profit for the government in the form of seigniorage (Black, 1987). This was the central motive in 1932, during the Machado administration, when the revenues from seigniorage were needed to solve a fiscal crisis. It seems that the peso is born, or at least it developed, in fiscal sin. Ironically, the reappearance of the peso-dollar dualism in 1993 follows a reverse order of events (peso first, dollar second) but the same type of motive; as government spending went out of control, implicit inflationary finance became imperative.[5] As a result, the peso is debased and the country must depend, once again, on the US dollar to conduct more efficient transactions and to provide a more reliable means to store wealth.[6] The importance of the US dollar was accurately described by Wallich (1950, p. 41, 42) in words that may turn out to be prophetic:

"The outstanding fact about the dollar circulation was undoubtedly the high degree of secular exchange stability it provided compared with what an independent currency might have offered. Through boom and depression, revolution and moratorium, the dollar gave Cuba an externally stable monetary system with a complete absence of exchange difficulties.[...]The outstanding characteristic of the dollar in Cuba was precisely that it could be neither stretched nor bent. In this sense businessmen are right when they speak of the dollar circulation as a great confidence-creating element."

Also in Wallich's words (1950,p. 42), "Cuba's money supply depended upon private bank lending and the automatic money-creating process of the balance of payments." This is valid today for the dollar side of the dual system, except that there will be no money creation by lending until the government creates or allows the creation of financial intermediaries.

Why then Cuba proceeded to found a central bank system in 1950? Even though the Banco Nacional de Cuba was not founded until ten years after they wrote this important book, Pérez and Pazos (1940, p. 38-41, 62, 64, 71, and 74) seem to suggest several reasons. One reason was to have a mechanism capable of stabilizing the exchange rate between the peso and the dollar. Once there was a peso circulating with the dollar, the rate of exchange between the two were bound to vary for different reasons, among them, the seasonality of the sugar industry throughout the year, the variations of the American and world sugar markets, all other factors affecting the balance of payments, and the changes in the supply of pesos. A second reason was to prevent capital flight by establishing exchange controls. It was felt that the export proceeds were not returning to the country in sufficient amounts, but the predominant ideas during those years made Pérez and Pazos think that the solution had to be based in a market intervention mechanism based in central banking.

A third reason was to provide "elasticity" to Cuban monetary system, meaning flexibility to manage monetary aggregates to control the level of credit, and enhance the government's ability to implement counter-cyclical or compensatory spending, as Keynes' ideas were becoming fashionable (Pérez and Pazos, p. 68-69). A fourth reason for the creation of an independent monetary authority was to save in seigniorage, and a fifth reason was based on a matter of national prestige. Central banking, besides, was becoming increasingly fashionable in Latin American countries, as well as different forms of government intervention in the economy, including Keynesian approaches to the business cycle and to the increasingly new topic of development policies by increasing the economic powers of government, via fiscal and monetary policies. Many influential sources also believed that a central bank was indispensable for Cuba to earn its "economic independence". A more explicit statement of this view can be found in Martínez (1959, p. 99).

B. The Panamanian System

As stated before, Moreno (1992) proposed the use of the Panamanian monetary system as an instrument for the Cuban transition towards a market economy. The Panamanian system is based entirely on the US dollar, though a small amount of fragmentary currency is allowed to circulate. The level of money supply in the Panamanian economy is endogenously determined by economic agents acting through the balance of payments. Disequilibria in the balance of payments are automatically corrected, without any intervention of a discretionary power. A reduction in exports, for instance, reduces money supply, *ceteris paribus*, and will produce an excess demand of money in the affected sector that, by Walras Law, will have to be matched by an exchange of non monetary assets by economic agents (private and public) or a corresponding reduction in expenditures (Moreno, 1992, p. 221).

The endogenous determination of the quantity of money contributes to the convergence between the local and the international rates of inflation (Moreno, 1992, p. 222). The level of government expenditures is constrained by the capacity to generate revenues and the obtention of foreign loans. Under these rules, the government does not have the power to issue money for political purposes, a chronic ill of Latin American economies and one of the disastrous condition of the Cuban economy. Interests rates in Panama tend also to converge with international rates, with a differential that reflects country risk. This convergence of interest rates facilitates foreign investment without foreign exchange risks and the existence of clear and stable rules. The system allows a free flow of capitals in and out of the country, including the withdrawals of profits (Moreno, 1992, p. 222-223).

The cost of the Panamanian system has been estimated by Moreno (1992, p. 224-225) as lower than the cost of a fiduciary system. Assuming a ten percent of interest rate foregone of the quantity of dollars circulating and five per cent of seigniorage the resulting figure (US$60 million) is still below the estimated cost of keeping foreign exchange reserves (US$82.5 million). The latter does not include the cost of administration of a central bank, nor the cost of printing and replacing the national currency. The system could be more cost efficient with the introduction of currency boards (Walters, 1987, p. 740), also mentioned by Moreno (1992, p. 232). As these entities are limited to replacing the foreign currency at par with a national currency (there is no deposits nor lending), part of the foreign currency can be put to earn interest while also protecting the country's wealth from the physical destruction of the "good" money.

II. Implementing Monetary Dualism in Cuba

The Panamanian system is not dual, despite the existence of a local fragmentary currency, and the Panamanian translation of the word dollar, the Balboa. In this system, money functions like commodity money, the way money in fact circulated in the world for centuries under a fixed exchange rate (Cooper, 1986, p. 85). For Cuba, the problem would be how to take advantage of such a system in the presence of an economy based on a debased peso? Replacing the peso with a dollar monetary system --something like a massive blood transfusion-- is not affordable and will not be discussed here.[7] The solution is to adopt a dual system, something that the Castro government has partially implemented yet without any apparent intention to use it with the same purpose as proposed here.

The following analysis is carried out under the assumption that there is a serious commitment to build a market economy in Cuba and that the corresponding government is willing to implement all necessary measures to that effect. The current legalization of the US dollar undoubtedly facilitates this process, but this proposal goes far beyond the framework allowed in Cuba thus far because it is based in a widespread decentralization of economic powers. In fact, the role of the government in charge of the transition should be limited to the creation of the legal system and the macroeconomic conditions required by a market economy. This government could also be allowed to produce public services, without excluding the possibility that some could be produced privately. More specifically, the assumed set of government policies goes along the lines of the paper by Sanguinetty (1993).

The guiding principle of monetary dualism for Cuba would be the separation of domestic money from foreign money. The central objective of the foreign money (in the form of the US dollar) is to signal all economic agents, domestic and foreign, private and public, that Cuba is an open economy with an extraordinary dependence on foreign trade, and with an even more extraordinary dependence on foreign currency for reconstruction purposes. The free circulation of the dollar will serve to readjust the Cuban economy after three decades of chronic and severe price distortions in product and factor markets.

The central objective of the domestic money (in the form of the Cuban peso) is to allow the government to achieve fiscal stability without an abrupt increase in unemployment by gradually but firmly decreasing the fiscal deficit, while giving time to the rest of the economy to generate employment via new investments and to absorb a certain amount of workers from the public sector into unemployment insurance plans. Instead of cutting the public payroll from the first day of the transition, there would be a reduction in real government expenditures by depreciating the salaries of redundant workers with continuing but dwindling short-term inflation financing. As real salaries depreciate, a fact that will be observed by all citizens on a day-to-day basis, there will be strong incentives for the workers of the peso economy to find or create employment in the dollar economy. The peso economy would be mostly represented by two types of public sector organizations, the enterprises that could be eventually privatized, and the agencies of the central government that must be funded from fiscal revenues.[8]

The first step in the implementation of monetary dualism as a transition monetary system for Cuba will be the enactment of laws declaring the US dollar and the Cuban peso as unlimited legal tender. This initial measure must be immediately complemented by the creation of a competitive private banking system that would allow national and foreign banks to start operations in Cuba. This would have to be preceded by the enactment of legislation and the production of regulations providing certain guarantees to the public about the soundness and credibility of the institutions. Laws guaranteeing total freedom of exchange between both (and any other currency) will also be enacted, including anti-trust legislation to severely punish monopoly positions, cornering, price fixing, and any other mechanism that impairs the working of free and competitive money markets. A critical aspect of the new rules would be to define the banking reserve requirements. There are persuasive arguments to keep such requirements at a minimum (Álvarez, 1993), but this is a topic that falls outside the scope of the paper and will not be discussed here.

The investments of new banks in Cuba would require an inflow of capital to start up operations that could add to the quantity of money (dollars) in circulation. The banks would then be allowed to conduct business (deposits, loans, etc.) in both currencies separately. There will be no restrictions to the movements of money in and out of the banks and the country, but the public would have enough information about the financial status of each bank to reduce uncertainty about conducting business with each institution.[9]

As banks start operating in Cuba, other business will be interested in major investments that can bring significant amounts of dollars into the economy. Particularly attractive will be the utilities. The modernization and expansion of the capacities in production and distribution of electricity can be expected to required investments well into the several hundred million dollars, as well as telephone and all forms of modern communications. But not all of the dollar value of these investments will engross the supply of dollars in Cuba. In varying proportions, such investments will have a cash component to finance local expenditures, especially salaries during the building stages and, later on, during the operating stage. The other component will be in kind, and will be represented by the equipment, building materials, technical assistance, and managerial labor required also for both stages, i.e., building and operations.

As the enterprises are privatized, those workers able to keep their jobs are expected to be paid competitive wages, in dollars or pesos, based on the economic conditions that prevail at each time.[10] In the beginning of the transition, such conditions can be expected to improve as the economic reconstruction advances and the levels of economic activity increase. After each privatization, the redundant workers would be transferred to a government payroll funded indefinitely with chronically shrinking real pesos, even if their nominal salaries are kept.[11] This pool of redundant, unemployed but not unsalaried workers would be expected to feed to growing demand for workers in the private sector as private investment continues to generate new jobs. Once they accept a job offer elsewhere in the economy, their salaries would be stopped. Nevertheless, the mechanism could be maintained permanently as an unemployment insurance system, but under a more deliberate financing framework.

A similar process of labor reallocation can be implemented in the government sector that does not include the enterprises, such as the ministries, the armed and security forces, the judiciary, the Communist Party, the labor unions, and other mass organizations with full- or part-time employees earning a salary. The characteristics of this sector, however, may require a slightly different treatment for nominal salaries. Unemployment here could be more difficult to reduce than in the private sector due to several reasons. Firstly, the size of the social programs has been the trump card of socialist propaganda, even if it was achieved at the expense of ruining the economy while covering up the process with hefty Soviet subsidies. Secondly, the structure of specific skills in the public sector do not facilitate their transfer to different activities in the private sector. For instance, they report a number of physicians at the rate of one per 500 inhabitants, a figure out of proportion with Cuba's ability to finance health services as if it had the economy of France or Belgium. Even if doctors were allowed to conduct private practice --a realistic expectation in a market economy-- it would not be surprising that their free market level of income would not be compatible with the expected rates of return of the investment in this form of human capital vis-a-vis other professions. Thirdly, the identification of a redundant worker in the private sector is generally easier than in the public sector for three reasons: a) the process is run in a decentralized way, b) the nature of the jobs makes it easier to determine levels of labor productivity, and c) there are no political factors involved in the hiring-firing decision. In any case, the rate of reduction of the public payroll will depend on how much employment is generated elsewhere, and how much labor redundance can be determined to exist in the non-enterprise public sector.

It is important to emphasize that the ability of the country to retain some of the social programs of the socialist era depends on the ability of the new system to attract fresh resources for investments. The dual monetary system helps in this respect to determine the level of public expenditures that the population will be willing to pay, once they know the cost of such programs by feeling them directly in their own pockets. As the monetary system establishes that the "solid" part of the money supply depends on the ability to export, government expenditures cannot grow in real terms unless the "real" economy inserts itself in the world's economy successfully and grows too, a *sine qua non* of our days for a small open economy.

The endogenous character of the dollar system will force the government to reach fiscal equilibrium in the peso system. If the government does not reduce the fiscal deficit, public sector real wages would continue decreasing while dollar wages may increase as the economy recovers. Under these circumstances, the public sector will lose employees to self-employment or to the private sector. In other words, disequilibrium is not feasible in the peso system in the long run as long as there is economic recovery fueled by a continuous influx of dollars and the concomitant investment activity and increase in employment. By not having any discretionary power on the monetary economy, the government must concentrate its attention in the real economy. But even if there is not enough influx of dollars to generate employment in the private sector (not an unlikely scenario if other crucial conditions are not met in the transition), the system will still exert a force in the direction of equilibrium as inflation in pesos will continue eroding the real wages. The process, however, will be slower because of lack of incentives to reallocate labor force to the private economy. Without sufficient investment and resulting employment generation, the adjustment will have to come via increases in self-employment, more consistent with the development of a close and stagnant economy of subsistence than with the development of a modern open economy. The performance of the transition government will then be more easily judged by its impact on the economy, as economic and fiscal management become more transparent, since the government no longer has the power to murky the waters through self-serving monetary policies.

In this system, exchange rates between the peso and the dollar fluctuate freely, but as investments mainly depend on the quantity of dollars, the exchange rate does not affect foreign money. For all practical purposes, exchange rate instability does not exist in the external sector of this monetary system. Gresham's Law, on the other hand, will not fully operate as long as two conditions are met. One condition is that exchange rates must always be determined by supply and demand operating freely in both currencies. The other condition is that the rates fluctuate within a certain range. Expectations about future peso inflation would obviously expand the demand for dollar for wealth storage purposes, including hoarding outside the banking system.[12]

Whether the Gresham's Law holds or not depends on the transition government's performance in managing the stabilization policy in peso terms. The credibility of the peso will measure the credibility of the government as reflected in the private demand for pesos. But whatever that credibility, it will not affect the credibility of the economy at large from the point of view of investment performance. The danger of government's incompetence will not affect the economic reconstruction of Cuba if it is protected by a set of well-designed rules instead of granting bureaucrats with excessive discretionary powers. This form of monetary dualism provides the new government with limited discretionary powers, sufficient to fix the mess created by a socialist administration but not enough to spoil the chances of a relatively fast economic reconstruction and recovery.

Finally, the implementation of monetary dualism should consider the creation of currency boards mentioned before. Such institutions are not banks and would be limited to exchange the US dollar for a national certificate or note at a fixed rate. Their functions would be to preserve the physical integrity of the US dollar circulating in the country (the boards would exchange worn out notes for new ones on a periodic basis), and to invest part of the dollar reserves in low risk securities. This mechanism would even reduce further the cost of this monetary system to the country.

A. Disadvantages

Most of the arguments about advantages and disadvantages of the proposed system of monetary dualism in Cuba have been part of the "rules versus discretion' controversy in monetary policy or, in a different form, the debate about free banking versus central banking. Despite some economists' contention that government intervention in managing the money supply is unanimously accepted by the profession (Klein, 1974), the debate about the pros and cons of each alternative begins with Walter Bagehot and Vera Smith in mid-nineteen century England and continues today with many advocates of both positions, among them Hayek and Friedman. Fischer (1990) and Goodhart (1991) provide good reading material on this topic.

Perhaps the most persuasive reasoning against discretion, and by association, against monetary dualism is that it severely limits the flexibility the policy maker may require to "to respond rapidly to contingencies not foreseen or not describable in the potential rule" (Fischer 1990, p. 1179). Under a flexible regime, the monetary authority can respond to external and unanticipated disturbances by managing monetary variables to affect output, employment and inflation to minimize a single-period loss function. Nevertheless, the defense of discretion or flexibility has been severely weaken by the theory of dynamic inconsistency which fundamentally posits that as long as the government does not have the power to make certain decisions, private agents will never expect it to make decisions that will turn out to be sub-optimal under discretion with respect to the optimal solution that can be reached by rules.

Another argument against a US dollar-based monetary dualism is that it depends on the soundness of US monetary policy. If the US monetary authority becomes more tolerant about inflation (to reduce the real value of its staggering public debt, for example), the Cuban economy would be directly affected as the value of its stock of money would be devalued at the same rate. Besides, unexpected inflation would affect investment decisions in Cuba in the same way that they would be affected in the US, by increasing the level of uncertainty in general, raising private investors' requirements for break-even rates of return in their investment and, possibly, triggering capital flight. But, what are the real chances of this to happen? In the short run, it does not seem likely and, in the worst-case scenario, hardly as damaging as Cuba not being capable of attracting sufficient capital for its reconstruction. In the long run, as Cuba achieves higher levels of growth, an independent monetary system does not have to be ruled out if the authorities earn the credibility of private agents.

Although the list of academic disadvantages could be made much longer, we will finish with a third argument against dualism. This is based on nationalistic values or concerns about Cuba's sovereignty and it basically assumes that the honor or independence of the country depends on its ability to have its national sign on the currency declared as legal tender. The rebuttal of this argument follows the same lines of the idea that national prestige depends on having an airline even if it is a losing proposition. As an extraordinarily open economy, each of Cuban industries, including its agriculture, is heavily dependent on imports. Why not import a monetary system if it serves the public good?

B. Advantages

All of the above arguments assume the existence of a responsible and competent policy-maker, one with a commitment to the public interest or, more rigorously, one whose single-period and inter-temporal loss functions are identical to the corresponding loss functions of private agents. But this is exactly the crux of the matter. What are the chances of having such a policy-maker in Cuba during the transition? Even in the context of more advanced political and economic systems, there are serious doubts about the risks of assuming such a policy maker. Milton Friedman, in a comment to an earlier draft of the paper by Fischer (1990, p. 1181), implicitly indicates that the behavior of the US Federal Reserve System from its birth can be more realistically described by loss functions that include so unorthodox variables as avoiding accountability and achieving public prestige, than by inflation and deviation from target output as variables. Cuba's monetary history from March 1952, when Batista deposed the constitutional government until today, accurately fits this condition, and there is no guarantee about the managerial competence and integrity of a future administration in Cuba. Therefore, the main advantage of monetary dualism is that limits the power of any administration to mishandle the Cuban economy, especially during the transition. Dualism, as stated earlier, will give enough discretionary power to the monetary authorities to clean up the mess of the current administration, and nothing else.

Another major advantage is that monetary dualism serves to convey to the Cuban population the idea that there are two economic systems in Cuba; one that has to be dismantled (represented by the peso) and one that has to be created (represented by the US dollar). The old system requires severe adjustments whose pains must be kept separate from the costs of creating new opportunities on the dollar side of the economy. The dollar side will also serve to convey the idea that Cuba is an open economy. That there is no government magic capable to produce miracles, and that overspending in social programs was only possible because Cuba was receiving gifts from its Soviet partners while they were in power, perhaps in return from military and other services rendered by Cubans in other countries (Angola, Ethiopia). Therefore, monetary dualism would generate clear market signals to encourage the free realignment of resources in the Cuban economy, after decades of the random distortions created by central planning and whimsical administration. Workers should be free and encouraged to move to export industries and this might require the reduction of manpower dedicated to internal security and the military. It may also reduce the ranks of the bureaucracy and even the levels of employment in the social programs. In the latter case, the level of reduction will depend on the level of productivity that can be achieved in the private enterprises and their ability to pay taxes. How much of the social programs can be kept will directly depends on the degree of success of the transition in creating employment with levels of productivity high enough to generate the required fiscal base. This critical relationship should be explained to the Cuban population for everyone to keep in mind that social programs must be financed by some one, and that there is no such thing as a free lunch.

III. Conclusions

The depth of the economic devastation inflicted upon the Cuban people by the incompetence and dogmatism of a once populist government is unparalleled in the annals of socialism. Ironically, the socialist economies of the Soviet Republics and Eastern Europe failed because of secular stagnation (accompanied by political dissatisfaction due to lack of freedom), not because of actual regression. A possible advantage for Cuba derived of this situation is that the Cuban population may be ready to try anything that holds a reasonable promise of a better future. The credibility of the transition government will be a major factor in this regard. Castro, however, has already facilitated this process by accepting as a *fait accompli* the legal circulation of the US dollar.

Though monetary dualism suggests a Hayeksian system of *competing currencies* (Visser, 1991, p. 75), it is in fact a mechanism of competing monetary systems. In the Cuban context, current conditions will also help to make monetary dualism an instrument to compare competing economic systems. Despite the lack of convincing evidence that the current policy measures in Cuba are serious and irreversible moves towards a market economy, the process may prove to be irreversible. In any case, the road is paved for experimentation by a transition government with the authority and the competence to try new economic institutions to expedite the reconstruction of its economy.

Along these lines, it is worth mentioning that a future monetary union with the United States may become of interest to the Cuban people. Following De Grauwe (1992, p. 1), and Moreno (1992, p. 235) Cuba may eventually go one step further and adopt the currency of a the United States. The relevant question is whether Cuba's welfare would increase by adopting the currency of a wider area. The analysis of costs and benefits for a Cuba-US monetary integration would be much easier than for the Maastricht Treaty (De Grauwe, 1992, p. 154).

In its Quixotic quest for economic independence (an ill-defined but recurring topic in Cuban public affairs), the Castro administration increased the countries vulnerability to external factors. The notion that Cuba today is less independent that what it was in 1958 may find little discrepancy among inhabitants of the island. And monetary autonomy and the peso were symbols of that independence. Nevertheless, none of these topics have been subjected to serious scrutiny for many decades. After Wallich (1950) no other economist has been known to approach this problem.

Though the concept of economic independence is ill-defined and sounds less relevant every day in an increasingly interdependent world economy, we must not be hasty in neglecting it. More analysis will be necessary on this topic. Even the alternative of returning to the old peso system should not be discarded if such an option must follow the mandate of the Cuban population some time in the future. Such a decision, however, should be made after all analytical possibilities have been explored in light of where the public good stands.

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Footnotes for:
Monetary Dualism as an Instrument Towards a Market Economy: The Cuban Case

Jorge A. Sanguinetty, Development Technologies, Inc.

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2 We use the term maximization because we do not believe that the country could achieve such a saturation point to render some investment undesirable provided, of course, that everything is done within the right legal framework, that "hot money" will not be especially important in this process (Calvo, 1993).Back to Text

3 We must bear in mind that the current administration in Cuba is offering strong incentives to foreign investors on the basis of what appears to be far from a free market economy, for instance, a captive labor market, monopolistic conditions, etc. These investments seem to be taking place under government guarantees of high rates of return after taxes.Back to Text

4 Coincidentally, Fidel Castro announced the legalization of US dollar holdings by private Cuban citizens in June of 1993, but the purpose was not to use it as an instrument of a transition to a market economy, but to recognize its overwhelming presence in the Cuban black markets.Back to Text

5 Implicit because inflation per se was not happening in official markets, due to price controls and rationing. The inflation, however, becomes apparent in the black markets that thrive as the government fails to fulfill the rationing quotas and the system breakdown.Back to Text

[6] Black market exchange rate reports put the dollar price in Cuba today at 75 pesos. In 1958 they were generally at par with some fluctuation. When the Banco Nacional was created in 1950, Cuba's international reserves were about US$800 million, equivalent to a year of its international trade. They were almost depleted by the Batista's government at the end of 1958, as a result of a spending program to gain popular support. This plus the flight of capital triggered by the advent of Castro's revolution started the decline of the Cuban peso reflected by the imposition of exchange controls in 1959. In the early sixties the dollar soon reached a price of three pesos and by the mid sixties the exchange was six to one in the black market. These dollars however were not used as a means of circulation in the merchandise black market, but as store of wealth and a means to transfer wealth to the US through triangular or quadrangular transactions highly persecuted by the Cuban government.Back to Text

7 This would be similar to the reunification of Germany, but Cuba does not have a Western sister.Back to Text

8 Even if some of the public goods and services can be produced by private means, many of them require public funding and, therefore, tax revenues.

9 Reporting requirements to the government and to the public (quality of information and periodicity) could be part of the requirements mandated by the government.Back to Text

10 Notice that unrealistic labor demands could severely impair the reconstruction process. If a labor oligarchy is allowed to prosper in lieu of a legitimate labor union movement, and if the policy makers do not bother to explain the policies to the population, demagoguery and impatience will combine to impede

a smooth transition to a market economy. The Russian case comes to mind at each step of this exercise.Back to Text

11 The reduction of nominal wages may be considered an interesting option to accelerate the stabilization of the domestic economy and add pressure to workers to create their own employment or accept lower salaries elsewhere in the economy. How far such cuts can go, or how fast the stabilization can be achieved clearly depends on the rate of change of the inflow of capital for new investments.Back to Text

12 Not a condition to be underestimated in Cuba during the transition after three decades without a banking system and very backward payment mechanisms. Back to Text