# JULIO CARRANZA AND PEDRO MONREAL ON ECONOMIC CHANGE IN CUBA: A CRITIQUE

Ernesto Hernández-Catá[1]

Since 1990, the Cuban economy has been coping with the effects of a massive withdrawal of external resources resulting from the elimination of Soviet subsidies and the collapse of Cuba's trade with former communist countries. The resulting problem could not be addressed in the way that is generally viewed as most appropriate, i.e., by combining adjustment and financing, because the financing part of the solution was not available. Cuba could not count on the support of multilateral financial institutions, from which it had withdrawn in the 1960's; financing from private or from official bilateral sources was unavailable, among other things because the Cuban government had built up a large stock of external arrears; and Russia did not have the resources or the political will to continue subsidizing the Cuban economy, even on a reduced scale. So the country had to adjust in full to the external shock.

Still, important options were open to Cuba's policy makers. The process of adjustment to the external shock could have been addressed by cutting domestic expenditure; by increasing output; or by a combination of the two. In the first phase, which covered roughly the period 1990-92, the Cuban economy adjusted essentially by brute force: in other words by squeezing domestic expenditure through generalized rationing. National income plunged,[2] imports dropped in relation to gross domestic product (GDP) from 25 percent in 1989 to 11 percent in 1992, and the trade deficit shrank from 8 percent of GDP to 3 percent (Table 1). According to Julio Carranza,[3] this policy of forcing external adjustment by repressing domestic demand—if it was indeed a coherent policy—was aimed at "an equitable sharing of the burden of adjustment" but also at avoiding a rise in inflation and a surge in unemployment. But these goals were not achieved.

The maintenance of massive domestic subsidies in spite of the loss of external resources led to a sharp rise in the budget deficit from approximately 4 percent of GDP in 1989 to 24 percent of GDP in 1992, and these deficits were financed largely by monetary expansion. In part, the inflationary consequences were repressed by continuing to control prices at levels that were increasingly away from equilibrium. This resulted in the involuntary accumulation of monetary balances by the population, thus creating the potential for a future surge in prices. The coun-

1. An earlier version of this paper was presented at the workshop on "The Future of Economic Reforms in Cuba" organized by Shaw, Pittman, Potts & Trowbridge, Washington, D.C., April 10, 1995. The views expressed in this paper are the author's and not necessarily those of the International Monetary Fund.

2. Estimates of the cumulative drop in GDP between 1989 and 1992 range between 23 and 39 percent. This paper uses an estimate published in the 1994 *Economic Report* of the National Bank of Cuba which puts the drop in GDP near the lower limit of that range. From 1989 to 1984, GDP probably fell somewhere between 34 percent and 48 percent.

3. Julio Carranza, "Los cambios económicos en Cuba: Problemas y desafíos," *Cuadernos de Nuestra América*, Vol XI, No. 22 (julio-diciembre 1994).

**Table 1. Cuba: Selected Macroeconomic Indicators**

| | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|
| **In Percent of GDP** | | | | | | |
| Government revenue | 35 | 43 | 46 | 50 | 52 | 69 |
| Government expenditure | 43 | 49 | 62 | 74 | 80 | 77 |
| Budget balance | -4 | -6 | -16 | -24 | -28 | -8 |
| Exports | 17 | 17 | 13 | 9 | 6 | 7 |
| Imports | 25 | 24 | 18 | 11 | 11 | 11 |
| Trade balance | -8 | -6 | -5 | -3 | -5 | -3 |
| **In billions of pesos** | | | | | | |
| Real GDP (1981 prices) | 19.6 | 19.0 | 17.0 | 15.0 | 12.8 | 12.9 |
| Budget balance | -1.4 | -2.0 | -3.8 | -4.9 | -5.0 | -1.4 |
| Trade balance | -2.7 | -2.0 | -1.3 | -0.5 | -0.9 | -0.6 |
| **Percentage changes** | | | | | | |
| Real GDP | 0.3 | -3.0 | -10.7 | -11.6 | -14.9 | 0.7 |
| Black market prices | 3 | 2 | 157 | 98 | 201 | 12 |
| Black market exchange rate (negative sign=depreciation) | -27 | -51 | -84 | -20 | 9 | 50 |

**Sources:** Jorge Pérez-López, *op. cit.*; data provided by Armando Lago and José Alonso; Cuban National Bank, *Economic Report, 1994;* Ministry of Economy and Planning, National Statistical Office; and author's estimates.

**Note:** Estimates of Cuba's nominal GDP are subject to an extraordinary margin of uncertainty as suggested by the counterintuitive behavior of the implicit GDP price deflator (for example, the deflator falls in 1991, a year of strong inflationary pressures in parallel and back markets). Accordingly, estimates expressed in percent of nominal GDP should be interpreted with considerable caution and should be used only to provide rough orders of magnitude.'

terpart of this excess supply of money was, of course, an excess demand for goods, which was eliminated by rationing in various forms, including queues and forced interruptions of water and power supply to the population. But high inflation was not avoided: part of the pressure resulting from monetary expansion found its way in parallel and black markets were prices increased at an average annual rate of about 150 percent in the period 1990-93.[4] Neither was the rise in unemployment avoided: it was merely disguised, with enterprises often shouldering the burden of keeping idle employees on the payrolls.

In late 1993 and 1994, the government adopted a seemingly more rational approach to adjustment. First, it restrained aggregate demand by raising excise taxes and cutting subsidies, thus reducing the need to resort to rationing, forced saving and the inflation tax, Second, it provided some incentives to expand production through a partial liberalization of agriculture and the legalization of some forms of self-employment.[5] The measures succeeded in reducing financial imbalances: the budget deficit, which had peaked at almost 30 percent of GDP in 1993, dropped to 8 percent of GDP in 1994. The monetary overhang was reduced and inflation in parallel and black markets apparently subsided. Third, a favorable treatment was given to foreign investment in certain sectors, particularly tourism, and residents were allowed access to specially designated, government controlled stores were they were authorized to spend the foreign currency they obtained from rela-

4. Based on data provided by José Alonso and Armando Lago.

5. For a summary of these measures, see Jorge Pérez-López, "The Cuban Economy in 1995," *Association for the Study of the Cuban Economy Newsletter* (June 1995).

tives in the United States or from certain transactions with non-residents. But the structural reforms were too timid, subject to too many restrictions and limitations, to yield a sufficiently strong supply response, and real GDP stagnated at a low level in 1994. Moreover, the policies adopted in 1993-94 have created a dual economy with a number of distortions and inequalities—between those who have access to foreign currency and those who do not, between the self-employed and those employed in the state sector, and between farmers and city-dwellers.

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Where will the Cuban economy go from here? A strategy aimed at achieving a lasting improvement in the standard of living of the Cuban population would have to combine continued adjustment on the demand side through a tight fiscal policy with a decisive effort to boost the supply of output by eliminating distortions and providing incentives to work and to produce. The proposals presented by Julio Carranza and Pedro Monreal[6] in their recent articles and in their oral presentations at the April 1995 meeting in Washington, D.C., with a group of Cuban-American economists are not consistent with this strategy. At times the authors do emphasize the need to increase economic efficiency, to base enterprise behavior on considerations of profitability and to expand the role of markets. But in the end their program envisages the maintenance of central planning (although it will be planning of a different nature, we are told), of major distortions and obstacles to the functioning of markets, and the perpetuation of a large state-controlled enterprise sector insulated from competitive pressures.

Their apparent affection for distorting policies is revealed most clearly in their brief reference to industrial policy (on page 3 of the "Proposals for discussion"), where they envisage the use of "economic tools such as duties and import permits, selective credit policies, direct allocation of hard currency, legally sanctioned monopolies, export subsidies, state orders, direct state investment in dynamic sectors, etc..." This reads like a collection of the policies that have distorted resource allocation and hindered growth in so many developing countries for so many years; and these policies are inconsistent with the authors' professed interest in the efficiency and the productivity of the economic system. Even if the scope of state control over the economy were to be reduced in the period ahead and the role of decentralized decision-making expanded, the use of instruments such as import permits and the direct allocation of credit and hard currencies will lead to rent-seeking behavior and lobbying by special interest groups, thus jeopardizing both efficiency at the micro level and financial discipline at the macro level.

Yet, efficiency and stability are the authors' stated goals. But throughout their writings these goals clash with their specific policy recommendations. This is particularly striking in Julio Carranza's proposals for enterprise reform. In his article titled "Los cambios económicos en Cuba," he states that enterprises should operate under a system of hard budget constraints ("régimen financiero fuerte") that provides the right incentives to maintain profitability. This is very encouraging. But is it consistent with Carranza's view of Cuba's future enterprise sector? He does envisage that the small, and most of the medium-size enterprises will be profit-oriented (although he adds, ominously, that they "will have to account for their economic results before the structures of Popular Power," whatever that might be). However, the large and medium-size enterprises "which have a major impact on overall economic relations" must be centralized and remain subject to the direct control of the government.

The word 'profitability' does not appear in the discussion of these large, state-controlled enterprises which, we are told, must remain the "central axis" of

6. See Carranza, *op. cit.*; and Pedro Monreal and Manuel Rúa del Llano, "Apertura y reforma de la economía cubana: Las transformaciones institucionales (1990-1993)," *Cuadernos de Nuestra America.*, Vol XI, No. 21 (enero-junio 1994). See also Carranza and Monreal, "Cuba: La reestructuración de la economía. (Una propuesta para el debate)," presented at the workshop on "The Future of Economic Reforms in Cuba," April 1995.

the economy. Presumably, this means that these enterprises—most of which are probably loss-making, have a redundant labor force and operate at dismally low levels of capacity—will not be subject to hard budget constraints. There is not a word about a plan to take a serious look at these enterprises to determine which ones should be restructured and which ones should be closed. And there is not a word about privatization. So, presumably, these enterprises will be kept afloat through budgetary transfers and centralized credits. And so they will continue to be a burden for the population and, as the experience of the former Soviet Union strongly suggests, a threat to macroeconomic stability. Cuba's budget deficit is still around 10 percent of GDP, and monetary financing on that scale is incompatible with low inflation.

Julio Carranza is understandably concerned about the monetary overhang in Cuba. He is also concerned about the fragmentation of the economy into a dollar sector and a peso sector—a fragmentation that distorts prices and wages and contributes to the misallocation of resources. His proposal to unify the currency is sensible. Moreover, I have no difficulty with the proposal of eliminating the dollar from circulation by exchanging it for the national currency. But this misses the point. The source of the distortions is not the fact that the dollar is allowed to circulate: it is the fact that it can only be used in specified sectors of the economy where the national currency cannot be used, and the fact that the two currencies cannot be freely exchanged for one another. Therefore, free convertibility of the national currency, together with unification of the official and free market exchange rates, is the real solution to the problem.

Similarly, the authors propose a currency reform as a solution to the problem of excess liquidity. This is a possible solution; I suspect its interest derives from the fact that it allows the confiscation of monetary balances above a specified threshold and therefore it can be used as an instrument of social policy. This is a double-edged sword because it will have obvious implications for the credibility of the government as a debtor. But more to the point, monetary reform by itself will not eliminate the distortions created by disequilibrium prices. The way to eliminate these distortions and also to get rid of the monetary overhang once and for all is to liberalize prices. The authors agree that this is part of the solution, but they assert that "the process of price liberalization necessarily must be partial and gradual." [7] They recognize that the coexistence of free prices and controlled prices will give rise to "tensions." That's putting it mildly. They should bear in mind the experience of Russia and the outcome of Gorbachev's disastrous attempt at partial and gradual decontrol of prices. In January 1992, Egor Gaidar freed all prices with one stroke of the pen, not because he had a taste for big bang solutions, but because goods had disappeared from the markets.

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To conclude, the basic problem faced by the authors results, I believe, from a *fundamental ambiguity at the level of strategic objectives*. On the one hand these objectives are defined as the achievement of "high rates of growth of output and employment, low inflation and external balance." But this must be done, we are told, "without jeopardizing the socialist essence" of the economic system. And in case there is any doubt, we are told that "planning is an essential instrument within a strategy aimed at the country's economic and social development in the medium and long term."[8] These objectives are mutually inconsistent.

I have read what Pedro Monreal said about the "complex learning process" through which the various economic and political leaders must go through,[9] and I understand his feeling that he must adopt a cautious approach to reform. I am not in a position to give tactical advice to those who influence economic policy in today's Cuba. I can only urge them

7. Carranza, *op. cit.*, p. 30.
8. Carranza, *op. cit.*, p. 38.
9. Monreal and Rúa del Llano, *op. cit.*

to look reality in the face and state clearly and unambiguously what I believe is wrong and must be changed.

Central planning has failed worldwide as a system because it has proved unable to provide for a lasting improvement in the standards of living of the population. It did not work well in Cuba, even when the government was able to provide social benefits at the expense of the Russian tax payer. I don't see why it should work now that the party is over. If the goal is to achieve lasting growth of output and employment as Carranza and Monreal tell us it is; if their cherished goal of social equity is to involve sharing prosperity—and not only sacrifices and poverty—then the reform program will have to be much more ambitious. It will have to pursue a genuine solution to the problem of large scale enterprises through a combination of restructuring and privatization, and to improve efficiency and avoid the perpetuation of subsidies that the population cannot afford to pay. It will have to seek the replacement of central planning by market mechanisms as the principal mode of resource allocation and realize that the only price reform that will work is full price liberalization. It will have to insist on freedom for the Cuban people to work, produce, and invest, and on their right to appropriate the benefits of their efforts. And it will have to call for a much more fundamental withdrawal of the state from economic life.