FINANCING THE ECONOMIC RECONSTRUCTION OF CUBA WHILE REBUILDING THE FINANCIAL SECTOR: PERSPECTIVES ON DEVELOPMENT BANKING

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Since the 1950s, development banks have evolved from their role as banks for everyone, usually funded by the Central Bank at subsidized terms, into that of specialized financial intermediaries, though still government-owned, but now lending primarily through commercial banks, under market-determined terms and conditions. Those countries that have succeeded in transforming the role of development banks along these lines, benefitted by the existence of a long-standing and viable banking system, which was able to efficiently assume those activities which had previously been performed by the development banks.

Because it lacks a financial sector infrastructure, Cuba is currently not equipped to implement an effective development financing strategy. Unfortunately, the liberalization of the economy, when it does occur, will require drastic and immediate action in certain areas, while a gradual and flexible approach in others, and as a consequence, it may not be possible to achieve the desired sequencing of first, rebuilding the financial sector, and second, implementing an economic reconstruction program. The final outcome may be somewhere between a big bang and a big bust.

Following the initial efforts at economic stabilization, which could actually trigger unstable reactions, the government will need to implement a comprehensive strategy to rebuild the economy's productive capacity, with a focus on the development of a viable financial system and the privatization of existing government enterprises. This paper reviews some of the critical issues dealing with the establishment of efficient development financing vehicles, which, at the same time, could serve as the catalyst for the development of the financial sector under private sector initiative. While some recommendations are made to assist in the development of private sector commercial banks, the principal focus of this paper is the role of development banks during the transition. This is not meant as a comprehensive analysis of all the relevant financial sector issues affecting the reconstruction and development of the economy, but rather a discussion of some highly relevant aspects. While some reference is made to experiences in Eastern Europe and the ex-Soviet republics with development banks and financial sector reforms, Cuba's experience is more likely to resemble that of its neighboring Latin American economies, but under a more severe case of disequilibrium and with greater haste in getting reforms through.

STABILIZATION IN AN UNSTABLE ENVIRONMENT

The starting point for any sustainable structural reform program should be an acceptably stable economic environment The design of the structural reform program should in turn depend on the country's initial conditions. For example, a pre-condition for the implementation of investment banking and capital market reforms should be the existence of a strong commercial banking sector, supported by a solid money market, and supervised by highly qualified regulators and responding to an autonomous and credible Central Bank as manager of monetary policy. If none of these conditions are present at the start of the a structural reform program, its design needs to be very simple and should focus on very few basic policies. Because of inadequate initial conditions, Cuba will be at a major disadvantage whenever the Government initiates any fundamental reform program. After more than 35 years of almost total Government control over the economy, where the official economy has operated in the absence of any (legal) market mechanisms, the return to a free market economy will be overwhelmingly difficult. This point has been articulated extensively in numerous academic studies on the subject, and clearly demonstrated by the experience of the ex-Soviet republics.[1]

The Cuban economy's dire initial conditions are likely to defy any attempts at stabilization, at least for a number of years. By a stable economy we usually mean a combination of low inflation, facilitated by a small fiscal deficit, and stable international reserves, which in turn will hinge on a normal response of exports and imports to market signals under a suitable currency management policy. During 1991-94, the economy suffered an unprecedented collapse, whereby production in the official market fell to about 20-25 percent of capacity.[2] At the same time, domestic prices as well as the price of the currency have been practically frozen since the early 1960s. Under these circumstances, the implementation of market reforms is bound to create an almost chaotic economic environment. There is no compelling evidence of any attempt to implement similar changes in other countries that have not produced major economic disruption. In some cases, a dramatic stabilization program accompanied by aggressive structural reforms has actually veered off the scale and worsened economic conditions, and thus further delayed the return to normal conditions. One of the more pertinent examples of this adverse response to reforms is the implementation of price liberalization which can unleash a hyper-inflationary spiral such as occurred in Russia after 1990. Inevitably these negative experiences raise the question of whether the ends justify the means. Should the objective of establishing a market-based economy override all costs incurred during the transition. Can the government adequately compensate all those adversely affected by the reforms? Or does it have the political capital to withstand widespread discontent and possibly social disorder?

In view of the great obstacles to change, the organization of stabilization and structural reform programs will be an extremely difficult task. As a pioneer of structural reform lending, the World Bank has learned many lessons in the design of sustainable structural reform programs. Two of the Bank's lessons which are of particular relevance to Cuba are: (i) when there are multiple distortions in the economy, the design of an optimal sequence of reforms is very difficult; and (ii) reforms that require the development of institutions and adequate human capital should proceed very cautiously.[3] On both of these counts, Cuba's prospects appear dim. Unraveling decades of distorted economic linkages in order to hastily design comprehensive structural reform programs will very likely produce highly undesirable results, and inflict severe hardship on the Cuban people. Because of its vulnerability to sudden changes in the economic environment, the financial sector will thus be exposed to a very high risk of collapse during the critical stabilization period.

A QUICK FIX COULD BE DEVASTATING

One of the buzz words in stabilization policies is shock treatment. The premise for this approach is that a radical change in the rules of the game would immediately produce a new desirable economic environment, and would thus wipe out any memory or any excess baggage from the past. If a reform-bound government were to decree free markets, after having

1. For additional references see Association for the Study of the Cuban Economy, *Cuba in Transition,* Volumes 2, 3 and 4, 1992, 1993 and 1994 respectively.

2. See Manuel Lasaga, "Dollarization: Scrambling for Foreign Exchange," in *CubaNews*, The Miami Herald, September 1993.

3. See Vittorio Corbo, Stanley Fisher, and Steven B. Webb, eds., *Adjustment Lending Revisited*, The World Bank, 1992.

exerted absolute control over the economy for many years, the shock therapy approach predicts that the morning after, economic agents will begin to operate efficiently using market signals as their *modus operandi.* In a comparative static analysis, this predicted outcome would appear to be a reasonable scenario. However, when we introduce a dynamic adjustment process in an unstable environment, the simplistic approach could be more harmful than the *status quo.* In this regard, the multilateral lending agencies have learned many lessons on the hazards of economic restructuring. Unfortunately, entrepreneurs are not created by simply legislating their existence. In fact, entrepreneurs are a very small minority within the business community, even in highly developed economies, and adding to their numbers is a slow evolutionary process.

In recent years the establishment of a fixed exchange rate regime, accompanied by the "dollarization" of the economy, with a monetary board which makes sure that every unit of local currency is backed by dollars, has been gaining popularity in countries that have experienced high inflation and severe international liquidity problems, and which seek a quick solution to these problems. This has been proposed as one of the economic stabilization mechanisms that Cuba could apply when it initiates a fundamental reform process. The fixed exchange rate mechanism as managed by a monetary board in effect represents a draw back to the days of the gold standard as it was applied to the currencies of the then existing colonies. Unfortunately the gold standard monetary system failed because of the lack of discipline by the member countries. The appeal of the fixed exchange rate mechanism lies in its simplicity. However, its sustainability calls for an exceedingly high level of fiscal, monetary, and economic discipline by all economic agents, which will be far beyond the reach of Cuba when it embarks on a perilous path to stabilization.

One of the risks of "dollarization" of the economy is that it could create a false sense of stability in thinking that the relative strength of the dollar would solve Cuba's economic problems, and that the stability and strength of the U.S. economy would be extended to Cuba through this currency linkage. The negative experience of Liberia and Panama with "dollarization" has diminished the credibility of this mechanism. While Panama survived major political and economic upheaval during the late 1980s, the existence of a dollarized economy did not prevent those problems from surfacing.

On the other hand, the use of a fixed exchange rate might be expedient under certain conditions, as when the monetary authorities seek to stabilize domestic prices, but only for a temporary period. The problem arises when the government locks in the mechanism, as if it could place economic management on automatic pilot, and refuses to change it even when the currency becomes grossly overvalued.

Because of its complexity, the financial system is highly vulnerable to rapid structural economic changes. Financial intermediation is a highly leveraged low-margin business where the primary determinant of profitability is the risk-adjusted interest rate margin. In the case of open economies, the banking system is exposed to yet another and sometimes devastating source of risk through currency fluctuations and highly volatile capital flows. Drastic changes in interest rates caused by dramatic shifts in economic policy could inflict irreparable damage on the operations of a financial intermediary. As a consequence, the use of quick fix or simplistic mechanisms could seriously undermine the stability of the financial sector. For example, locking in the value of the currency with respect to the dollar, could create a false sense of security as banks fund dollars overseas and then make dollar denominated loans to local companies. However, their borrowers could be totally un-hedged. A collapse of the financial system brought on by sudden shifts in the economic environment would result in a severe liquidity crunch in the economy that could then trigger a major depression.

FLOWING WITH THE CURRENT

The possibility that the Cuban economy will enter a period of instability during the transition to a market-based system, combined with the vulnerability of the financial sector to unpredictable events, would support the use of a flexible approach in setting transition policies. Proper sequencing of structural reforms is essential, but sometimes it may be necessary to put aside the logical structures and pursue a more eclectic approach. At other times gradual changes may be more appropriate than shock treatment. The pitfall of policy makers would be to try to fit the Cuban economy into a rigid model that is inconsistent with the initial conditions.

Emphasis should be placed on the quality of the economic management team and its ability to navigate in a tumultuous climate. Economic advice should be taken only after careful consideration of Cuba's unique situation, specially its unstable initial conditions. One of the lessons from reform programs in other countries is that the design of structural reforms should be determined on a case-by-case basis. Economic models based on the experiences of other countries that have adopted dramatic economic reforms should be referenced in making policy decisions; but at the same time, these models should be discarded if they lead to undesirable consequences. Once again, the economic management team will have to decide when to change the course, even if it means changing the course for structural reforms that may take many years to produce the expected results, and yet the government does not have the luxury of time to see the final outcome. Successful passage through the transition to a market-based economy will mean that Cuba will have written its own textbook on the reform process.

ECONOMIC POLICY GUIDELINES OF RELEVANCE TO THE DEVELOPMENT OF THE FINANCIAL SECTOR

This discussion does not attempt to identify all the components of a comprehensive economic reform program, but to present those elements of importance to the development of the financial sector, and more specifically, to the establishment of a viable development banking institution(s). Satisfactory management of these policy areas is a basic requirement for the sustainable expansion of the financial sector and thus the transition from a viable development banking led reconstruction of the economy to a sustainable private sector led commercial banking system.

Price and interest rate liberalization

Price and interest rate liberalization will perhaps be the most unpredictable and potentially disruptive element of a stabilization program. In an ideal situation, domestic prices should be market-determined. The fact that prices have been set rigidly for decades, raises the potential of a hyper-inflationary spiral during the transition period. The ability to curtail the fiscal deficit while shrinking the role of the government in the economy will be a critical factor in the success of any price stabilization strategy. No enduring progress will ever be achieved in the financial sector without first drastically reducing the fiscal deficit, and second, instituting a credible monetary authority, so that price stability can be reasonably assured. The importance of controlling the fiscal deficit in achieving price stability can never be over-emphasized. Even with satisfactory progress in the implementation of stabilization policies, the lack of supply responses to price signals, inherent in a collapsed economy in which the government has controlled all decisions, and which lacks the basic corporate unit of economic organization, is bound to intensify inflationary pressures from any price liberalization.

Chronic inflationary problems will impede the development of the financial sector by exacerbating economic volatility, which will thus discourage domestic financial savings, and by raising real interest rates to unsustainable levels, will severely limit access to credit as well as threaten the quality of the newly emerging banks' portfolios.

In addition to price stability, one of the basic conditions for an efficient financial system is the existence of market determined interest rates. However, during the transition period, there may not be a feasible market mechanism for determining interest rates. The government may have to assume an interventionist role by setting interest rates, preferably by use of a formula which would assure that rates reflect a reasonable return to savers, or that they compensate for the time value of money adjusted by the level of risk in the financial system. Once the market mechanisms to negotiate interest rates are put in place, liberalization of rates should be phased in.

Clear rules of the game

The safety and soundness of the financial sector will hinge on the reconstruction of Cuba's legal and regulatory infrastructure. A credible constitution, along with a basic body of laws governing, among others, commercial and banking activities, are primordial conditions. The question of property rights and pending resolution to property claims dating back to the time of the 1959 revolution would have to be resolved quickly. The establishment of a land registry which allows the issuance of valid titles will be an essential ingredient for the development of mortgage-based lending. If the lengthy process associated with the passage of economic reform legislation in other Latin American countries is an indication, then the establishment of these basic legal ingredients for the development of a rudimentary market-based capitalist system in Cuba will pose a major challenge to the government during the transition.

Effective enforcement of the rules

The passage of appropriate legislation governing economic activity and its regulation is only a first step towards sustainable economic development. The key to success is in the adequacy of enforcement mechanisms. The recent episodes of financial sector crises in Latin America can be attributed in part to excessive risk taking resulting from inadequate supervision. For example, Mexico had made important changes in its banking legislation during 1990-91, which set the stage for the subsequent privatization of the banks that had been nationalized in 1982. Nevertheless, the banks failed to implement adequate risk management procedures, and the authorities failed to respond to these problems until after a full-fledged financial crisis had erupted.

Cuba lacks both the legal infrastructure and the supervisory capabilities that will in turn support the development of a financial sector. There are no laws supporting the establishment of corporations to do business, no generally accepted accounting standards, no property rights, and the current government has no experience in managing a market-based economy.[4]

One of the more troublesome issues in the enforcement of new laws and regulations will be the ability of the government to control black-market or criminal activities. There is practically no information on the current size and scope of the black-market in Cuba. In view of the recent collapse of the official economy, the absence of famine or other serious health problems would indicate that the black market is thriving. People are able to survive by engaging in so-called criminal activities. If the government were to liberalize the economy and allow free markets, would the economic agents in the illegal markets then have an incentive to participate in a formal economy where they would have to pay taxes and to abstain from certain questionable practices? The answer to this question will depend on the present value of their expected profits under the new system compared to their expected profits from continuing to engage in illegal market activities, where the benefits from engaging in illegal franchises would have to be adjusted by the expected value of potential penalties if any are to be enforced. Criminal forces may also be able to resist attempts by a legitimate government to eliminate their illegal activities. Due to the lack of information on the size of the black market or its activities, there are no good answers to these questions.

Currency liberalization with selective foreign exchange controls

During the transition period the peso will be subjected to maxi-devaluations as domestic prices begin to catch up to market realities and the government seeks to promote a competitive economy supported by a dynamic export sector. At some point it may be desirable to manipulate the value of the currency in order to combat inflationary pressures. Foreign exchange controls could be used selectively. Another option would be the use of tariffs to indirectly adjust the value of the currency by increasing the cost of imports and the benefits to exports. The use of a dual

4. There are a limited number of special purpose corporations such as of joint ventures with foreign investors, and those that engage in international trade.

currency market could provide some temporary relief for essential goods. Whatever mechanisms are chosen, their departure from generally accepted market-determined operating procedures should be viewed as a temporary phenomenon. Unfortunately experience amply demonstrates that once a government deviates from the pro-market approach to economic policy, it is very difficult to reinstate market principles. Nevertheless, there is no easy solution to the problem of getting the currency to float near a stable equilibrium. A drastic liberalization of the currency could have the undesirable result of adding three digits to the exchange rate without moving closer to equilibrium.

While the government may decide to actively manage the currency during the transition, the trading of the currency should be dispersed extensively via the financial sector in preparation for an eventual liberalization of the currency markets. For this reason, banks should be allowed to trade in foreign exchange, and not have a separate entity such as the foreign exchange houses which may be more difficult to supervise, and which have a tendency to lure transactions that evade foreign exchange controls.

Privatization

Following the initial phase of stabilization and economic liberalization, the government will need to implement a comprehensive strategy to rebuild the economy's production capacity, with a focus on the privatization of existing government enterprises. The establishment of a privatization agency charged with the implementation of the government's privatization strategies should be a high priority. This agency could become the financial agent in charge of preparing the necessary valuations and initial public offering documentation, and subsequently conducting the sale of the shares, whether directly to individual investors or through a public auction.

External Debt

Access to the international financial markets hinges on the borrower's economic performance as well as on current and past status regarding debt service payments. Relations between Cuba and the international financial community deteriorated sharply during the 1980s. The economic collapse, triggered by the withdrawal of Soviet aid in the early 1990s, was also caused by Cuba's inability to obtain other sources of financing due to its record of non-payment on external debt. The bulk of the current external debt is owed to Russia, formerly the Soviet Union. Since a good part of this debt is denominated in rubles, the disintegration in the value of the ruble in dollar terms has created an opportunity for Cuba to repay all its Russian debt at a pittance in dollar terms, but this would have to be done before the peso is allowed to float, and thus before the resulting change in the cross-rate between the peso and the ruble make this debt expensive once again. With respect to its hard currency debt, Cuba will need to initiate negotiations with its creditors, since the participation of foreign banks in the reconstruction of the economy hinges on a satisfactory settlement of existing obligations.

One of the debt reduction mechanisms, which was developed during the debt crisis of the 1980s, is the debt-equity swap. Cuba has already been utilizing this facility to attract foreign investments from Europe and the Western Hemisphere. The use of debt-equity swaps, whenever these are properly managed in terms of exchange ratios and monetary consequences, should be continued.

AN EMBRYONIC FINANCIAL SECTOR

Because of its unique condition, there is no ready-made paradigm for the rebuilding of Cuba's financial system. While the lessons of other comparable countries will provide useful insights, the development of Cuba's financial sector will be driven by its own political-economic environment, and as a consequence, the final outcome will not only repeat the mistakes of others, but will also give rise to many new ones, just as it will also create new innovative mechanisms to deal with the challenges of financing the reconstruction of the economy while developing the financial sector. Sometimes the lessons from a country could actually become the mistakes for another. For example, recommending that the monetary authorities of a country assure that domestic interest rates reflect a positive margin over the inflation rate, could backfire in a country which is receiving a large inflow of foreign capital, since the higher domestic interest rates would further intensify the capital inflows and thus complicate the management of the monetary aggregates.

The issues raised by this paper deal primarily with the embryonic stage in the development of Cuba's financial sector, whenever the government decides to implement a fundamental economic reform program as described above. The three principal players during this initial transition period would be the *Banco Nacional de Cuba* (BNC) as Central Bank, a strong development bank, and a limited number of private sector commercial banks. As proposed by the Cuban Banking Study Group, the development of the private banking sector during the transition period could be accomplished by the establishment of a banking consortium comprised of the government's development bank, foreign commercial banks, and the previously expropriated banks, whose owners would have the right to apply for reactivation of their banking licenses.[5] The development of the capital markets, which would include investment banking, insurance, and pension funds would follow in a subsequent phase.

This proposal thus emphasizes the need for sequencing in terms of the principal institutional structures. Doing everything at once, without appropriate mechanisms and controls, could lead to unstable conditions. Proponents of an immediate open house for all financial services base their recommendation on the presumption that this would create a dynamic environment for financial innovation driven by competitive forces. However, the validity of their conclusions would depend on the freedom of entry and exit, on the availability of experienced professionals, on responsible behavior by all players, and on the existence of viable market mechanisms. In a country where markets have not functioned for more than 35 years, the notion that an entrepreneurial financial sector culture could be created overnight is not a realistic assumption. For this reason, the development of the financial sector will need to follow a sequential process with a strong role for development banks during the transition. While another option would be for the government to allow foreign banks to practically divvy up Cuba's financial sector among themselves, this would not be a politically viable solution, and one which no other country has found acceptable.

Current Status of the Financial Sector

The expropriation of all commercial banks in 1960, marked the end of the formal banking system in Cuba.[6] Subsequently, the Central Bank, *Banco Nacional de Cuba* (BNC) became the principal financial intermediary with more than 200 branches throughout the country. In effect the BNC assumed the dual role of Central Bank and commercial bank. In 1983, the government established a new entity called *Banco Popular de Ahorros* with more than 500 agencies and branches throughout the country accepting savings accounts from small savers, and offering consumer and mortgage loans. In addition, *Banco Financiero Internacional*, was established as an offshore banking vehicle to manage the government's international trade accounts, and to act as agent bank for foreign corporations operating under joint venture partnerships in Cuba. Since 1984, foreign banks have been allowed to establish representative offices in Cuba. Several European banks have opened representative offices mostly to serve their home country clients doing business in Cuba, and to finance Cuban exports, in which case they use the export commodities as collateral for the loans.

The current financial system is in a primitive stage of development. Operating procedures are inadequate, and thus the quality of the financial system's assets are highly questionable. Reliable information on the financial condition of the above mentioned banks is almost non-existent. Under these conditions, it is reasonable to conclude that after the expropriation of

5. The idea to create a private sector consortium of domestic banks, through the reactivation of the banking licenses of the confiscated banks, and with the participation of foreign banks was proposed in *The Creation of UNIBANCO, A Consortium of National and International Banks*, by the Cuban Banking Study Group, Inc., November 1994.

6. For more information see *Cuba: Past, Present and Future of its Banking and Financial System*, Cuban Banking Study Group, Inc., 1995.

the banks in 1960, financial intermediation basically disappeared, except for international trade, which is dependent on the expertise of *Banco Financiero Internacional*. Because of the poor state of the banking system as it exists today, this proposal recommends the establishment of *de novo* institutions rather than attempting to retrofit the current insolvent institutions, with the exception of BNC, which would go back to serving its role as the Central Bank.

Central Bank as credible manager of monetary policy

The rebuilding of Cuba's financial system will need to begin with the reinstatement of *Banco Nacional de Cuba's* (BNC) original charter as the nation's central bank functioning as an autonomous entity.[7] The rebuilding of the Cuban economy should be based on prudent economic management implemented by a credible monetary authority under the auspices of the BNC.

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 functional structure 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, needs to be compatible with an appropriate level of reserves necessary for the stability of the financial 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 rediscount 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 effect 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. The development of a viable domestic money and capital market in Cuba may not be realizable until a later stage of development. During the transition period, BNC may have to limit its open market operations to the establishment of a special money desk to manage the purchase and sale of government securities directly with commercial banks via telephone lines.

Since foreign assets represent one of the components of the monetary aggregates, the central bank should be designated as the guardian of international reserves, and act as the regulator of the foreign exchange market.

A revamped BNC should not extend credit to the economy, but only use its rediscount window as an instrument of monetary policy, or for temporary support for banks experiencing liquidity problems. In this regard, BNC's existing branching network should be downsized considerably, and many of the branches could be transferred to the development bank as well as to the newly emerging commercial banks. The existing loan portfolio could be transferred to a Government Trust, which would then contract with the development bank or commercial banks to perform the loan servicing function. In effect, the government would eventually assume any losses from these loans.

7. For further discussion see M. Lasaga and Jorge Salazar-Carrillo, *The Reorganization of the Cuban Central Bank in a Post-Castro Cuba*, August 1993.

Not only should BNC avoid interfering with the banking system's credit allocation mechanism, but it should not intervene in the setting of interest rates. However, during the potentially unstable transition period, when there is likely to be a severe liquidity constraint, BNC might prefer to set interest rates on a very selective basis, with the understanding that within a specified timetable, rates would become market determined.

A strong development bank as protagonist of the reconstruction process

With the new wave of economic reforms in Latin America that followed the debt crisis in the 1980s, the role of the development bank has been firmly recasted as a facilitator in the development process, with the principal intermediary role assigned to private sector financial institutions. Prior to the debt crisis, development banks had become a type of bank for all which provided, in many cases, highly subsidized loans which were funded on-demand with loans from the central banks. Many were designed to have a monopoly over long-term financing, on the assumption that commercial banks were unwilling to take that type of risk. The lending criteria applied by development banks was mostly inadequate and subject to political influence, and thus their portfolios were cluttered with doubtful loans. Few achieved sustainable profitability, and in fact many were eventually liquidated.

The fact that development banking institutions, as previously structured, had failed to achieve their objectives does not necessarily justify their elimination. At the same time, the persistence of market failures still hinders the ability of private sector financial institutions to assume the dual role of commercial and development banking. The recent financial crises throughout Latin America also point to a lack of maturity in the financial sector which applies to both public and private sector intermediaries.

Despite the errors of the past, development banks are still a very important part of the financing equation. Having learned from experience, governments have restructured development banks to play a supporting role to private sector financial intermediaries. Development banks can address the following market needs:

- Limited Access to financing: Micro-, small- and some medium-scale enterprises typically have great difficulty in obtaining financing from the commercial banking sector.[8]
- Lack of long-term funding: In order to grow, a company needs to invest in fixed assets. However, medium- and long-term financing is very scarce due in turn to the commercial banks' limited access to medium- and long-term deposits and borrowing, both domestic and foreign.
- Problem of information and transaction costs: financial intermediaries have a comparative advantage in managing credit risk due to their ability to obtain critical information on the financial position of their borrowers. However, the lack of credit history and other relevant operating information on prospective clients is much harder to obtain in the case of small- and medium-sized companies, or in markets which have not yet developed a reliable information network. At the same time, the cost of underwriting a loan may be greater than the actual amount of the loan if the borrower is a micro-scale enterprise whose borrowing requirements are very small.

In the case of Cuba, these market imperfections are greatly magnified. The primitive stage of development of the financial sector, not to mention the absence of a client base, since there is no viable private sector, would necessitate the use of a strong development banking institution to serve as catalyst for the reconstruction of the financial sector. Simultaneously, the government would need to institute a special purpose vehicle capable of organizing a viable commercial banking sector that would eventually assume the leading financial intermediary role. A banking consortium which would include both foreign and domestic banks could serve as the catalyst for the de-

8. One exception would be small- to medium-sized companies that are part of a large and profitable holding company.

velopment of the private banking sector. During the transition, the development bank could serve as the principal funding vehicle, which would then on-lend these resources via the banking consortium to the final borrowers. A critical element of the Cuban Banking Study Group's recommendation is that the banking consortium have a limited life. After an acceptable transition period, the operations of the consortium would be phased out, and the participating banks would then be expected to become independent banking entities, having gained valuable market experience as part of the consortium. Nevertheless, once the consortium is phased out, any qualified entity should be allowed to apply for a banking license.

Organization of BANFOR

A National Bank for Reconstruction and Development (BANFOR) could assume the initial responsibility, along with a private sector banking consortium, to finance the reconstruction of the economy and to promote the development of the banking sector.[9] BANFOR would serve as the bridge between the current communist-based de-capitalized economy, and a market-based private sector led sustainable recovery. During the transition period BANFOR would play a dominant role in securing financial resources for the reconstruction of the economy.

This proposal calls for the establishment of a *de-novo* development banking entity. In line with the recommendation to downsize BNC's banking activities, the other government bank, *Banco Popular de Ahorros*, should likewise be downsized with most of its branches transferred to BANFOR, and its loan portfolio also transferred to a Government Trust, while the servicing of the portfolio would be performed by BANFOR or the commercial banking consortium. BANFOR would be a joint venture between the public and private sectors. It would serve as the principal vehicle to allocate external development credits from bilateral and multilateral agencies, as well as from the government's own resources, to support infrastructure and private sector development. All credit lines extended to BANFOR would be guaranteed by the government.

The bank could be structured as a mezzanine-type financial organization that would operate through the private banking system, or during the transition period, through the above mentioned consortium of commercial banks. BANFOR would thus serve as a financial intermediary that would source funds overseas as well as in the domestic capital market, and channel these funds to final borrowers through the commercial banking system. Under this arrangement, the commercial banks would assume the risk of the final borrower. In effect, BANFOR would provide loans, priced under market conditions, through participating financial institutions to private sector enterprises. The final credit decisions would be made by commercial banks, while BANFOR would manage its own risk through supervision of the loan processing by the banks and through its selection of participating banks that are deemed to be creditworthy.

The objectives of BANFOR would include: (i) to assist with the reconstruction of the Cuban economy by allocating economic aid from the international community to the private sector; (ii) to participate in the privatization of public sector enterprises; (iii) to support the government's economic development policies, including support of the development of efficient and competitive enterprises in the private sector; (iv) to provide financial resources to micro- and small-scale enterprises; and (v) to contribute to the development of the private banking system through the establishment of a bank training institute.

The initial capital of the bank would consist of an amount to be determined by the government, and to be subscribed by both the public sector and private financial institutions. The government would maintain 51 percent ownership of the bank, while private commercial banks would own the remaining 49 per-

9. Some of the material in this section was first developed in Alberto García Tuñón, José Garrigo, and Manuel Lasaga, *Cuba's Development Financing: National Bank for Reconstruction and Development (BANFOR)*, October 1994, prepared for the Cuban Banking Study Group.

cent. In order to qualify for participation in BANFOR's financing facilities, a private commercial bank would have to be a stockholder in BANFOR.

The Board of BANFOR would consist of nine directors: five public sector, and four private commercial bank representatives. It is important that both public and private sectors work jointly in the promotion of private sector enterprises. The government's majority control would result from its role in determining economic development policies, as well as its position as final guarantor for BANFOR's lines of credits. Private sector participation on the Board would assure critical input in the areas of credit policy and management philosophy of the institution. It would also strengthen BANFOR's knowledge of the marketplace.

Activities of BANFOR

During the initial phase of economic reconstruction, BANFOR would play an active role in channeling economic assistance to priority sectors of the economy. It would become the public sector's financing vehicle to support private sector development. However, from its creation, BANFOR would be prohibited from providing any type of lending, directly or indirectly, to the public sector, except when involved in the privatization of government enterprises. Nor would it be allowed to underwrite guarantees on behalf of the government. As the principal source of funds for the economy during the initial transition period, BANFOR would have to adhere strictly to checks and balances, and to policies and procedures that would ensure the safety and soundness of the financial system. Lending to the government or in response to government directives would compromise the goal of promoting an efficient private sector-led banking system.

One of the critical elements of a structural reform program will be the privatization of government entities. Most of the major transactions during the transition period involving some type of financing are bound to be associated with the sale of government interests. BANFOR could play an active role in this process as the agent for the government. Once the government identifies a candidate for privatization, it could proceed along the following steps: (i) the enterprise would be incorporated; (ii) the government would deposit its shares with BANFOR; and (iii) acting as agent, BANFOR would arrange for the valuation of the company's assets, prepare the public offering documents, supervise the bidding and select the best offer. BANFOR could also provide financing for the purchase of the shares. At the same time, the proceeds from privatization could be used to support the lending activities of BANFOR. Under this scheme BANFOR would issue medium- and long-term bonds denominated in foreign currency that would be exchanged with the government for the proceeds from the privatization of government-owned enterprises.

BANFOR could provide local as well as foreign currency denominated loans. Its sources of funds would include loans from bilateral and multilateral agencies' under the guarantee of the government; lines of credit from domestic and foreign financial institutions; and issuance of its own obligations in the domestic and international capital markets. BANFOR would lend only to participating domestic financial institutions which, in turn, would assume the credit risk of loans made to final borrowers, except when under government guarantees. As administrator of multinational lines of credit, BANFOR would be responsible for supervision of its credits to participating banks, and periodic accounting of all relevant information on the distribution and impact of loans made under each credit facility.

BANFOR would provide medium- to long-term financing for both fixed assets and permanent working capital. Participating financial institutions would be able to discount individual loans, or, based on a predetermined loan approval limit, discount a group of loans, or simply work under a line of credit directly from BANFOR. All loans would be priced at market determined interest rates. In the case of dollar based funding, BANFOR would be expected to pass through the exchange rate risk to the final borrower, except during the initial reconstruction phase, when the government may find it necessary to assume such a risk directly in order to entice private sector investment.

During the period of economic reconstruction and rebuilding of the financial sector, BANFOR may need to pay special attention to the needs of the micro- and small-scale enterprises as well as to the availability of financing in the rural context. The lack of capital and collateral is bound to forestall the growth of all newly created enterprises, both large and small. At the same time, financial intermediaries will not be able to make good credit decisions without predictable earnings or prior track record for potential borrowers. In the case of micro- and small-scale enterprises, these same obstacles will be much greater. In this regard, BANFOR may need to make available special facilities to support lending to these small entities. It may have to subsidize the information and transaction costs via technical assistance to micro- and small-scale enterprises to perform project evaluations and to prepare the loan applications. Some creative but effective mechanisms will have to be developed to substitute for the lack of credit history and limited amount of capital and collateral by loan applicants.

Due to the lack of a formal nationwide branching network with access to rural areas, BANFOR could assume the responsibility for establishing a rural credit bureau. In order to promote the participation of private commercial banks in lending to the rural sector, BANFOR loans to small companies through its rural credit bureaus could be limited to medium-term tenor, without the possibility of refinancing or new lines of credit. After an initial period, performing loans could be packaged and placed with commercial banks, thus facilitating the transition both for the borrower, who would then achieve access to the formal banking sector, and for the commercial banks, which would then be able to acquire loans that have a performance record.

Nurturing a banking sector while operating in a high risk environment

The development of a dynamic banking industry in Cuba will take time. Even in some Latin American countries with more than a century of banking experience, major structural problems persist. Cuba will be no exception. A stable macroeconomic environment is a primordial condition for a healthy banking system. However, the ability of private sector financial intermediaries to channel resources from savings into investment, while managing risks efficiently, will hinge on the development of a critical mass of environmental factors which include the following: (i) a legal infrastructure in terms of the banking and commercial codes; (ii) adequate human capital in the terms of experienced and knowledgeable bankers; (iii) ample supply of financial market instruments; (iv) existence of acceptable forms of collateral; and (v) comprehensive and effective supervision. By serving as the focal point for all government banking activities, BANFOR could play a useful role in the development of these requisite environmental factors during the transition.

One of the traditional roles of development banks has been the training of banking professionals.[10] Through access to foreign-based technical assistance on risk management techniques and efficient financial intermediation, development banks have been able to pass on this expertise to its personnel, who in turn pass on these techniques to other commercial banks with whom they participate, or who may themselves eventually move on to private sector financial institutions, and thus apply the expertise they had acquired as development bankers.

Because of the absence of commercial banking activity for more than 35 years, there is a shortage of local banking personnel in Cuba. In order to speed the adjustment process during the transition, BANFOR could establish a technical banking institute that would offer a formal program in banking. The faculty for these training programs could be comprised of BANFOR Banking Institute staff, local University professors, local bankers, and international experts in the field of banking.

One of the obstacles to the financing of Cuba's reconstruction will be a lack of domestic financial savings. Even though commercial banks will begin to of-

10. See Mario Rietti, *Money and Banking in Latin America*, Praeger Publishers, 1979.

fer savings and time deposit instruments at supposedly adequate interest rates, which would be considered to be positive in inflation adjusted terms or would be considered a favorable rate when compared to the return on foreign based assets, depositors may not feel comfortable with these newly created financial institutions. For that reason, BANFOR could act as a facilitator by issuing investment certificates which would be used to attract local savings, and then make these funds available to participating commercial banks.

FROM DEVELOPMENT BANKING TO COMMERCIAL BANKING

Because of the likelihood of economic instability, of policy back-tracking or inappropriate quick fix policies, of inadequate structural underpinnings, the management of the financial sector development should be based on a sequential process. This proposal calls for a two-stage process in the rebuilding of Cuba's banking system. During phase I, the development bank (BANFOR) would assume the lead role in the financing of Cuba's reconstruction as well as in the development of the banking system. After a clearly defined transition period, which would allow sufficient time to launch a self sustaining commercial banking system under adequate supervision, phase II would begin with the gradual conversion to homegrown and foreign-owned private sector banks. The length of the transition would depend on the success of the proposed banking consortium in preparing its participating private sector intermediaries to assume the role of independent banks.

Since the mid-1980s, the design of structural reforms in Latin America has featured the private sector as the principal protagonist of the financial sector. This proposal does not contradict these developments, it supports an identical strategy for Cuba, except during the initial transition period when a development bank, with the government as majority and the private sector as minority shareholders, will assume a broad scope of responsibilities.

Analysis of development banking failures have led to the conclusion that most development financing functions should be managed by private sector commercial banks which are supposed to be market-driven and thus more efficient. However, these conclusions may be lopsided in that they fail to address similar risk problems within the private banking system. Some of the most spectacular bank failures in recent history, Chile in 1982, Venezuela in 1994, and Mexico in 1995, have originated within the private sector.[11] In this regard, the issue of banking system risk may go much beyond the question of public versus private sector ownership, and thus deserves further analysis. In fact, there are many profitable public sector enterprises.

The recent history of public and private sector banking failures points to the lack of adequate regulatory supervision as one of the principal problems.[12] If a banking system operates under strict adherence to the principles of safety and soundness, and if regulators assure compliance with these basic rules of the game, then the principal source of risk to the banking system would only be local and global market risks. Ideally, through diversification, banks would be able to reduce local risk and, in the end, be exposed to non-diversifiable global market risk. And if appropriate asset/liability management polices are implemented, banks could further reduce their risk and thus enhance their possibilities for profit maximization. The financial crises in Latin America that began with the onslaught of the debt crisis in the early 1980s repeatedly point to a lack of regulatory supervision, and to excess risk taking on the part of the banks, which, absent any deviant management behavior, can be traced back to the banks' directors and to the shareholders they represent. Therefore, in a well structured and properly supervised financial sector environment,

11. The term failure is used in the technical sense, since in the named examples the government assumed the financial cost of a technically insolvent situation.

12. For the importance of a proper regulatory framework see Joseph E. Stiglitz, "The Design of Financial Systems for the Newly Emerging Democracies of Eastern Europe," in C. Clague and G. Rausser, eds., *The Emergence of Market Economies in Eastern Europe*, Blackwell Publishers.

both public and private sector banks should make credit decisions under the same creditworthiness standards. Their objective functions may differ, but their intermediation techniques would be the same.

Phase I: Development bank as the lead intermediary

During Phase I, the development bank (BANFOR) would assume a leadership position in both the financing of Cuba's reconstruction and in the development of the banking sector. This should in no way detract from the very important task of setting in motion a viable private sector banking system. However, this proposal envisions BANFOR as acting as the principal financial intermediary during the transition period. The length of the transition period will depend on how much damage is incurred as a result of the initial steps towards a market-based economy, and on how quickly either the private sector consortium or other private banking entities can get their operations rolling on a profitable path. The critical element in this proposal is that Phase I will have a limited time span, and that inevitably the banking sector will be dominated by private sector intermediaries.

The principal objectives of Phase I would be: (i) to ensure an effective flow of resources from bilateral donors and from multilateral agencies aimed at rebuilding the country's infrastructure; (ii) to provide resources to local enterprises to finance investment where the funding for those loans originates with multilateral lending agencies; (iii) to maximize the benefits from privatization in terms of revenues generated for the public sector and of jobs created through the newly privatized companies; and (iv) to build the human capital skills necessary to support the development of a home-grown banking network. The time frame for the achievement of these objectives could be well defined given that their outcomes are quantifiable. On the other hand, once the private sector banks begin to expand in a sustainable fashion, they should develop much greater appetite for lending, and would thus surpass BANFOR in market share, so that initially the private banks' share of the market might be as low as 20 percent, as measured by total assets, and, by the beginning of Phase II would reach two-thirds share.

It may be necessary for BANFOR to act as a direct lender during Phase I, although these activities could be limited through the bank's credit policies. Initially, some projects might be too large for the embryonic banking sector, however, BANFOR could underwrite the credit and then sell participations to other banks. A government-owned bank that dominates the banking sector could help to reduce the possibilities of a banking collapse. Hardy and Lahiri conclude in their analysis of Eastern Europe that a dramatic change in the economic structure could trigger the collapse of a very inexperienced banking sector.[13] In this regard, Phase I could serve as a bridge during the critical period of economic instability with one intermediary firmly in control, and thus helping to build depositors' confidence, while giving time for the new commercial banks to get their operations firmly established.

Phase II: Home-grown and foreign-owned banks take the lead

Historically, the government has played a major role in the development of the financial sector in Latin America. Unfortunately, its involvement, though well intentioned, was detrimental to the healthy development of private sector financial intermediaries. Distorted macroeconomic policies such as over-valued currencies and controls over interest rates, combined with cheap and bountiful central bank credits to the commercial banks, produced inefficient, non-competitive and highly risky financial intermediaries. This proposal considers Phase II as the critical point in the development of Cuba's financial sector. If successful, Phase I will have established a sound structure made up of commercial banks that will have proven their ability to intermediate efficiently in a rapidly emerging market. During Phase II, BAN-

13. See Daniel C. Hardy and Ashok Kumar Lahiri, "Bank Insolvency and Stabilization in Eastern Europe," in *IMF Staff Papers,* December 1992.

FOR would assume a secondary role in the financial system with most of its lending activities by then channelled through the banking system.

The commercial banking system should evolve in an open environment which allows both domestic and foreign-owned banks to compete on a level playing field. Nevertheless, during the transition, domestic banks should be given some preference in terms of their ability to capture market share, as has been done by all countries whether big or small, industrialized or newly emerging. For example, recent reforms in Latin America to open the local markets to foreign bank participation have emerged only after their own home-grown institutions have enjoyed a near absolute monopoly for many years.

The success of Phase II will hinge on the development of an effective Superintendency of Banks with a legal mandate and adequate resources to supervise the banking system. Both public and private sector banks should be subject to the same regulatory requirements. The status of an autonomous agency would reinforce the Superintendency's credibility and effectiveness. Nevertheless, some overlapping of functions between the Superintendency and the Central Bank might be useful, since the Central Bank's technical expertise in financial markets and foreign exchange management could strengthen the Superintendency's supervisory function.

Phase III: The unfinished agenda

As stated earlier in this proposal, the immediate goals of the Government during a transition to a market-based economy should be to rebuild the commercial banking system. Undoubtedly the development of the equity markets, insurance, and pension funds are essential for the sustainability of economic growth and development. In that regard efforts should be undertaken from the start to institute the legal groundwork for the establishment of capital markets. However, the successful development of a credible Central Bank, an efficient development bank, a competitive commercial banking system, and an efficient money market should take priority over the development of the other capital market components. The risk of a collapse is much greater when everything is done at once, specially when it will all have to be built from the ground up.