INSTITUTION-BUILDING: FINANCIAL SECTOR REFORM IN CUBA

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Although financial reform is a difficult first step for achieving economic prosperity, the theoretical and empirical literature demonstrate that it is also a powerful tool for propelling economic growth. However, the reform process is also filled with a myriad of potential quagmires that can jeopardize both long-term and short-term economic development in transition economies.

In recent years, Cuba has begun to pursue financial reform in an effort to achieve economic revitalization. The Cuban government has made it clear that it will not abandon socialism, but it has realized that a greater level of decentralization is essential for its financial system to play a more modern and active role in ensuring efficiency in and adequate capital flows to the most productive sectors of its economy.[1] However, the complex nature of financial reform demonstrates that Cuba needs to answer several policy questions before embarking on this task: First, how does its tradition, history and culture fit into the financial reform equation? Second, what kind of financial system does it want to establish? How much private ownership is the government willing to allow? And third, how can the current institutional framework be used to carry out the financial reform program? What new institutions need to be established to support a strict regulatory and supervisory framework in the country?[2]

It is not clear how many of these questions Cuba has answered before embarking on financial reform.

1. "We don't deceive anyone. We are not offering our foreign partners a transition to capitalism. Cuba is and will continue to be a socialist country," Carlos Lage, Vice-President of the Council of State, as quoted in a January 27, 1995 address at the World Economic Forum in Davos, Switzerland. See Travieso-Díaz and Escobar (1995, p. 386). Previously, Lage (quoted in Mesa-Lago 1994, p. 65) has also stated that, "[w]e have no need to create a [new] economic model because the one we want and are defending is the socialist one." Before the National Assembly, at the end of 1993, Fidel Castro, President of the Council of State (quoted in Mesa-Lago 1994, p. 65), declared, "I have some convictions I will never resign: I do believe in socialism [and] the better I know capitalism, the more I love socialism...it has more solutions to our problems than capitalism... We must make socialism efficient and not destroy it... The steps backward we must take now should not discourage us because, tomorrow, we will be taking steps forward...this is nothing new...back in 1917, Lenin suggested [it]."

2. I will use the definition of regulation and supervision as stated by Castañeda and Montalván (1996, p. 6): "**Regulation** is the joint group of laws, rules and procedures established within a country to provide investors, depositors and financial institutions with transparent information regarding the economic risk in which they incur, while at the same time ensuring the security of the financial system and of any of its agents in order to prevent malpractice, corruption, fraud and embezzlement. The regulations include criteria and requirements for the entrance of new institutions wishing to operate in the system, accounting procedures and statements of financial condition, limits for the concentration of loans and limits to the exposure of individuals or related groups, minimum capital requirements, conditions of liquidity, collateral, classification and provisioning of reserves for liquidity and for financial losses from dilapidated assets, as well as the frequency and content of auditing. **Supervision** refers to the monitoring of and following-up on financial institutions by the respective authorities, as well as enforcing compliance to regulation and policy in order to prevent excessive risk taking and general incompetence."

Nevertheless, Cuba seems to be firmly riding on the financial reform bandwagon. However, its efforts have been gradual, emphasizing institution-building the most while paying the least attention to the development of new financial instruments.

Mehran et al (1996, p. 3) state that financial reform can be visualized as an economic triad consisting of institution-building, financial instrument development and price liberalization. They say:

> Analytically, it is useful to conceive financial sector development as a balanced development of the triangle of institutions, instruments and markets. The first element includes the establishment of banks and other financial institutions, as well as of infrastructure, such as the payments system. The instrument leg refers to the development of a range of financial instruments available to market participants to invest and trade. Development of the third component, markets, presupposes the free operation of the price mechanism across financial markets. Without price flexibility, financial markets do not mature either to support trade and investment or to conduct economic policy.

Given the realities of the Cuban financial system today and its early stages of development, this essay will focus on the first elements of financial reform: the institutional framework—including effective regulation and supervision—as well as existing or emerging financial infrastructure. Meanwhile, discussion of the other two arms of the triad will be limited since little change has occurred in these areas.

The essay will argue that the Cuban government needs to proceed faster in the development of financial institutions and their supporting regulatory and supervisory mechanisms in order to achieve an economic transformation within the economy: a transformation from classical socialism to what could be called a market-oriented socialist system, where the economy functions with a little of its own logic.[3] Under such a system, the development of a pro-competitive and efficient institutional framework is pivotal for achieving the emergence of a dynamic private sector. Furthermore, the essay will draw considerably from the experience of the recent reform economies—particularly from that of China and Eastern Europe—in order to apply the lessons from these countries to the Cuban case. By means of this analysis and through a thorough study of Cuba's existing institutional framework, the paper expects to prove that existing institutions are insufficient to revitalize Cuba's economic performance and to stimulate sustained growth and development. Thus, the essay encourages the Cuban government to continue reforming its financial system via a process that emphasizes further institutional reform and the development of new infrastructure and improved financial instruments. Although the third triad—price liberalization—will not be discussed in this essay, the author does understand that it is an important piece of the reform process and will recommend its gradual implementation, but only after a strong institutional framework has been firmly established.

THE ONSET OF FINANCIAL REFORM IN CUBA

The Banco Nacional de Cuba (BNC) continues to operate today as Cuba's chief central, commercial and development banking institution. As such, it is responsible for issuing credit and currency, financing capital investment, and handling all of the country's international transactions. In addition, the BNC has

3. I prefer the term "reform economy" to "transition economy", since the former refers to any economy engaging in a process of self-reform while the latter relates to an economy making a direct switch from one economic system to another. Carranza et al (1995, p. 7) allude to this fact: "In the context of a socialist economy, we must understand that economic reform is not just a change in the central planning mechanism, but rather modifications to the foundations of the system, which imply a change to new economic elements... The history of socialist economic reform demonstrates that the more radical experiments have been exceptional such as the so-called New Economic Mechanism (NEM), applied in Hungary in 1968, and more recently to the Vietnamese economic reform process. On the other hand, 'the deepening' of reform in countries like Hungary and Poland, towards the end of the 1980's, constituted an important challenge to the central planning mechanism, but their political evolution quickly placed these experiences on the road of the so-called 'post-communist' transitions rather than on that of the socialist reform economies." The author believes that Cuba falls in the latter category since it seems to be pursuing limited reform towards a system of "market-oriented socialism." Likewise, China and Vietnam would fall under the same category.

the authority to approve or reject all joint venture proposals, and is responsible for both overseas payments and the restructuring and renegotiation of Cuba's external debt (Triana Cordoví and Plasencia interviews; "Cuba Opens" 1996; EIU 1995-96, p. 30). However, with growing decentralization, it is becoming increasingly harder for the BNC to satisfy its growing demand for specialized financial services. As a result, Cuban scholars and leaders seem to agree that in order to satisfy the growing demand for these services, the government will need to formally institutionalize a two-tier banking system similar to those established by the economies of Eastern Europe, communist East Asia, and the former Soviet Union (Echevarría Vallejo (1996, p. 22; Soberón Valdés 1995, p. 8; Triana Cordoví and Plasencia interviews). This legal framework would clearly limit the role of the BNC's influence in the economy, as well as recognize the benefits that private-owned financial intermediation can bestow upon a developing economy.

Although between 1978 and 1984 the Cuban government had set the groundwork for financial sector reform, a period of economic retrenchment in later years had slowed down institution building progress. In fact, the BNC granted only two licenses to financial institutions in the decade that followed the passage of this law. However, growing decentralization in Cuba during the early 1990's has led to an increased emphasis on the establishment of new financial institutions, including the licensing of a new holding company—Grupo Nueva Banca, S.A. (GNB)—to provide specialized financial services to the emerging private sector. In addition, the government has laid the groundwork for the establishment of the Banco Central de Cuba (Central Bank of Cuba, CBC). Although the CBC is still pending approval from the Council of State, it is expected to become operational sometime in 1997. Finally, in a limited effort to engage in directed development, the government will reorganize the BNC into two policy banks—the Banco Agro-Industrial y de Comercio (BAIC) and a second bank keeping the same name. The Cuban government's principal objective with the reform is to better access foreign capital in order to provide loans for the prefinancing and financing of large-scale agricultural and industrial ventures on the island (Triana Cordoví interview). The BPA, the BAIC and the BNC will remain as independent banks, but similar to other existing financial institutions, will be subjected to the CBC's direct regulation and supervision. These institutions are discussed in greater detail below.

Banco Popular de Ahorro (BPA)

Although the BPA was created as an independent retail bank during the 1978 to 1984 economic reform period, it still maintains a departmental character and is subject to the BNC's direct control. Officially, the BPA's purpose is to promote savings by collecting deposits, carry out day-to-day banking transactions for Cuban citizens, issue credit to private individuals at commercial terms, and act as the government's accident and fire hazard insurance provider (BNC 1995, p. 28; Soberón Valdés 1995, p. 12). However, from 1983 up to the early 1990's, the bank was relatively backwards, lacking the financial infrastructure required to perform many of these transactions. Thus, recent reform will seek to modernize the bank so that it may gradually emerge from its private banking role and become a universal commercial bank in the near future (BNC 1995, p. 28; Soberón Valdés 1995, p. 12). Moreover, during the economic crisis of the early 1990's, the BPA became an extremely important tool for extracting excess circulation from the economy since 60% of the island's deposits at the time were in this bank. Its success has helped the BPA expand into a network of 275 branches throughout the island.[4]

Banco Financiero Internacional, S.A. (BFI)

Founded in November 1984, the BFI is a financial institution operating solely with convertible currency in commercial banking activities. Its goal is that of

4. There is some dispute over the exact figures. According to Babún (1996, p. 191), the BPA has already established close to 275 branches throughout the country. Other sources indicate that the number is 249. Thus, to be conservative, I assume that the "true" figure is between 225 and 275, depending on what is defined as a "branch." BNC (1995, p. 28); Soberón Valdés (1995, p. 12).

providing financial advice, preparing prefinancing arrangements on large-scale foreign investment, as well as raising capital with which to finance joint venture projects. At the same time, the BFI offers conventional banking services such as term deposits, current accounts and letters of credit (Babún 1996, p. 192). Finally, the bank also provides exchange services at market rates.[5] The BFI has grown significantly since it was established in 1984, and now possesses a correspondent relationship with 200 banks worldwide, as well as a total branch network of 14 or 15 throughout the island.[6] According to the island's policy-makers, this institution has become the "bank of choice" for financing joint ventures in Cuba.[7]

Cuba's Future Policy-Lenders

According to Mehran et al (1996, p. 14), "the separation of policy lending from commercial lending has become a critical issue" in economic development since it can serve as a transitory step for the commercialization of state-owned banks. In countries like China and Cuba, however, the legislation does not clearly distinguish or separate commercial lending from policy lending. Nevertheless, the success of public financial institutions (e.g., government-owned development banks) in countries like Japan, Korea, and Taiwan demonstrate that such institutions are vital towards the success of a directed credit policy.[8] Most of these countries have been more successful than others in the world because of their emphasis on institution building, bank supervision and regulation. In China, where the government initially relied on the formation and subsequent development of specialized banks, it is too early to evaluate their performance (Mehran et al 1996, p. 4). Mehran et al (1996, p. 14) define policy lending in any of the following five ways:

1. *Power and Infrastructure Investment Loans.* These are financially sound investments, but are generally risky in the short-term as a result of their size and long-term repayment periods.
2. *Fixed Asset Loans.* These are provided to state-owned firms to enhance their technological capability.
3. *Rural Development Loans.* These loans are granted for the development of agriculture, rural areas, and for the alleviation of poverty. These loans usually entail significant risk.
4. *Working Capital Loans.* These type of loans are generally risky in reform economies due to the relatively large numbers of loss-making enterprises.
5. *Subsidized Sector Loans.* Any loan granted to a subsidized economic sector such as health or education.

In the case of Cuba, as in China, there is no strict definition for a policy lending bank as of yet and may encompass any of the definitions set out by Mehran et al. In addition, no real policy lending institution exists in Cuba at the time. However, the Cuban government expects to create some soon when it transforms the BNC's remaining 214 branches and agencies into the Banco Agro-Industrial y de Comercio (BAIC). In addition, the BNC will continue to oper-

5. "The bank provides exchange services among freely convertible currencies, at the rates prescribed by the market at large, most notably the NYSE and other applicable exchange-rate authorities." Babún (1996, p. 192).

6. BNC (1995) provides contradictory information on the BFI. On page 28, it states that the BFI possesses 14 branches, while on page 29 it says that the BFI possesses 15. In any case, the Cuban government foresees the opening of 7 more offices in the near future.

7. Triana Cordoví and Plasencia interviews. Babún (1996) states that in Cuba "the two dominant banks are the Banco Financiero Internacional (BFI), which commenced operations in 1984, and the Banco Internacional de Comercio (BIC), which opened in 1994."

8. During the early stages of Japan's industrialization drive, for instance, the Ministry of International Trade and Industry (MITI)—which controlled foreign exchange and exerted considerable influence over the banking sector's capital financing—pursued a strategy of "picking the winners," and thus, provided preferential interest rates, low-cost financing and government-guaranteed loans to "winning" industries. Prestowitz (1988). Similarly, in South Korea, the government created development institutions which exerted direct control over available credit and planned investment in strategic economic sectors. Datta-Chaudhuri (1990). In both cases, however, the government disciplined producers by setting minimum production and profitability requirements in order to prevent moral hazard problems and to ensure the economy's efficient growth and development.

ate in a much more limited and streamlined fashion. Although the BAIC's organizational structure has yet to be revealed publicly, the institution will be expected to serve in the near future as a policy lender in government projects (BNC 1995, p. 28; EIU 1996-97, p. 32). However, the Cuban government expects the BAIC to naturally evolve into the leading provider of commercial banking services on the island (BNC 1995, p. 28; Plasencia interview). Meanwhile, the BNC will maintain its current responsibility of financing the country's existing external debt. In addition, the bank will be expected to provide state-owned enterprises with the essential capital to develop strategic sectors of Cuba's nascent modern economy (BNC 1995, p. 28).

Despite the success of such institutions in several East Asian economies, Mehran et al (1996, p. 14) caution other countries considering implementing similar institutions with which to finance their economic development for two reasons. First, unrestrained policy lending can prove extremely inflationary. Second, governments usually find it difficult to regulate the commercialization of the state-owned banks while simultaneously supervising policy lending activities. Nevertheless, the success of the East Asian model demonstrates that policy lending—under the right set of conditions—can assist a country to dramatically bolster its economic growth and development.

Grupo Nueva Banca, S.A. (GNB)

In an attempt to expand the number of financial services available to foreign investors and liberalized firms on the island, the Cuban government has established the GNB, a holding company for a network of recently-created financial institutions. Although its creation has paved the way for the establishment of an independent national banking system, however, the GNB remains controlled by the Cuban government. Currently, the GNB has a majority stake in each of the recently created institutions, which are—in the order of their founding—BICSA, FINSA, CADECA, Banco de Inversiones, S.A., and Banco Metropolitano, S.A. (EIU 1996-97, p. 32). These institutions—as well as their holding company—shall be under the regulatory authority of the CBC, which will be responsible for their supervision ("Cuba Opens" 1996; Plasencia interview). The section that follows outlines the major aspects of each of these institutions, and explains the role they play or will play in Cuba's economic development:

Banco Internacional de Comercio, S.A. (BICSA): Similar to BFI, BICSA was established in January 1994 with a share capital of $10 million as a merchant bank operating in Cuban pesos and in convertible currency. Its objective is to secure financing arrangements with foreign lenders for Cuban institutions and joint ventures. However, it also offers a wide range of conventional banking services, such as term deposits, current accounts, letters of credit and exchange transfers (Babún 1996, p. 192). Due to similarity in scope of operation, BICSA is already considered a dominant player in the industry and is currently BFI's most direct competitor (Triana Cordoví, Plasencia and Mulet interviews; Soberón Valdés 1995, p. 12; BNC 1996, p. 28).

Financiera Nacional, S.A. (FINSA): In April 1995, the Cuban government established FINSA as an export-import bank. Its purpose since then has been to provide working capital and short-term finance on a fee basis to Cuban enterprises. In addition, this institution provides financial advice and lends support in arranging lines of credit as well as leasing and factoring agreements. All its operations are undertaken in convertible currency (Triana Cordoví and Plasencia interviews; Soberón Valdés 1995, p. 12; BNC 1995, p. 28; BNC 1996, p. 28).

Casas de Cambio, S.A. (CADECA): CADECA was established in October 1995 as a network of currency exchange houses. Currently, CADECA consists of 16 to 20 foreign exchange houses whose principal clients are the nearly one million tourists who visit Cuba each year, the 72 state-owned enterprises that already operate in foreign currency, and private citizens who have access to foreign exchange.[9] In addition, by setting prices based on supply and demand, CADECA has helped to diminish black market activity in foreign currency transactions (Echevarría Vallejo 1996, p. 24; Soberón Valdés 1995, p. 12; BNC 1995, p. 28; Plasencia interview).

Banco de Inversiones, S.A.: Banco de Inversiones, S.A. was created in August 1996 to provide financial advice and investment banking services to both national and foreign enterprises. The bank's main objective is that of attracting and fostering investment in Cuba. As a result, the investment bank will seek to establish itself rather quickly in the international capital markets in order to carry out highly-specialized transactions, such as brokerage, derivatives and debt-to-equity swaps. By gaining access to the international markets, the Cuban government hopes the bank can secure capital for medium- and long-term development finance operations. In addition, the bank may help deal with enterprise and financial restructuring by providing the technical expertise and advice needed for this to occur (BNC 1995, p. 29; BNC 1996, p. 29; U.S.-Cuba Business Council 1996, p. 8; Plasencia interview).

Banco Metropolitano, S.A.: Banco Metropolitano, S.A. was founded in June 1996 in the Vedado neighborhood of La Habana. The bank was created as a result of a divestiture of the BNC's international branch. Its purpose is to provide banking, stock brokerage services and financial advice to foreign companies, personnel and diplomatic corps residing in Cuba. The bank performs its financial transactions—such as checks and deposits—in both national and convertible currency ("Cuba Opens" 1996; BNC 1996, pp. 28-29; Plasencia interview; Babún 1996, p. 193).

The GNB-owned institutions continue to operate within largely segmented financial markets; nevertheless, their profitability has improved enormously during their short time of existence. For instance, BICSA has grown to become a major competitor of the BFI with a superb average return on equity of 127.8% and an average return on total assets of 9.41% (BICSA 1996, p. 15). Whether this success continues will depend largely on the successful development of the economy. As was mentioned earlier, the simultaneous success of enterprise reform and continued liberalization will be critical to these efforts.

Although economic deepening has helped to recover positive profit margins in some firms, 69% of the country's enterprises as of May 1994 were operating with losses (Carranza Valdés et al 1995, p. 28; Mesa-Lago 1994, p. 50). The extent to which this problem has been solved is unknown since most available research within and outside of Cuba provides relatively little information on this regard. Thus, the problem of bad loan portfolios in Cuba will not be addressed in this paper. However, considering the common traits and characteristics shared by pre-1989 Cuba with the reform economies in Eastern Europe, the former Soviet Union and communist East Asia, one can safely assume that bad loan portfolios continue to constitute a widespread problem within the island's financial sector. As a result, it is fair to say that the development of the GNB's institutions, as well as that of other financial institutions within the country, will largely depend on their ability to effectively deal with this problem.[10]

Banco Central de Cuba (CBC)

By divesting its commercial branches, the Cuban government expects to transform the BNC into a truly independent central bank. Although the CBC's future institutional role in the economy has yet to be defined, the existence of an independent central bank

9. BNC (1996, p. 28) states that there are 14 CADECA offices in Ciudad de la Habana, 1 in Varadero and 1 in Santiago de Cuba. However, another source (EIU 1996-97) states that there are 20 such offices throughout the country. The recent opening of offices in Holguín and Villa Clara may account for the difference.

10. An example of another group that has actively participated in Cuba's financial sector development is Grupo ACEMEX. Founded in 1974 as a group of financial companies that specialize in shipping and financial activities, Grupo ACEMEX's scope of activities has gradually been expanded to meet the growing demands of the recovering economy. Among the services provided by Grupo ACEMEX's financing institutions are providing credit for prefinancing and short-term financing, engaging in factoring and leasing agreements, as well as managing the financial activities of the Group's private companies. Since its creation, "the ACEMEX Group has arranged credits for its clients amounting to $612.0 million, of which approximately $89.0 million were directly provided by its financing institution." Brochure for Acemex Management Company n.d., pp. 1, 16.

will help to vastly improve the resource allocation process on the island.

Based on the financial sector's current demands, most experts agree that the CBC's role will be that of overseeing the monetary flows within the liberalized sectors of the economy in order to stifle its inflationary pressures, stabilize the exchange rate, and help curtail the government's fiscal deficit (Soberón Valdés 1995, p. 9). To ensure the fulfillment of this objective, the Cuban government is expected to empower the CBC with various financial instruments—such as interest rate manipulation—with which to stabilize the economy.

However, the Cuban government is conscious that it will need to instill confidence in the financial system in order to succeed. For instance, to establish its credibility in the public eye, the CBC will need to engage in strict supervision of the enterprise and financial sectors. In this manner, the CBC can minimize the risk of widespread insolvency, while strengthening the economy's deposit base currently at nearly 5.4 million accounts. (Echevarría Vallejo 1996, p. 23; Soberón Valdés 1995, p. 8). As such, the CBC is expected to emerge as the regulatory and supervisory authority of the commercial sector. However, to ensure enforcement of the CBC's policies, the Cuban government will need to confer upon it broad powers such as that of removing bank managers based on negligence, lack of compliance or lack of preparation. Strict enforcement of the CBC's policies would prevent the resurgence of capital inadequacy and preempt the need of taking over the bank's management (Roe 1995, p. 17). As a result, the CBC can help to create a more efficient supervisory and regulatory mechanism that in turn can expand and improve financial intermediation, lead to greater financial deepening in the economy, instill confidence in the payments system, and in turn, promote economic development on the island (Soberón Valdés 1995, p. 9).

Foreign Financial Institutions in Cuba

By prohibiting foreign financial institutions from operating branches on the island, the Cuban government has greatly inhibited their activities in the financial sector. As of June 1994, foreign banks have only been allowed to establish representative offices in Cuba, with the purpose of identifying prospective investors to whom they can offer specialized financial advice regarding new investment opportunities. Thus, a local presence entitles foreign banks faster access to the Cuban market, which in turn allows them to discern high-return investment opportunities particularly in the growing joint venture market (EIU 1996-97, p. 33). The opening of a local office is a strategic decision for a foreign bank since it provides new business contacts and prepares the groundwork for the eventual establishment of a fully-operational branch on the island.[11]

To date, approximately thirteen banks have taken advantage of this opportunity (BNC 1996, p. 29). For example, even before 1994, a prominent European financial institution engaged in trade finance had established offices in Cuba via subsidiaries to perform very limited financial services ("Cuba's Pre-Revolution Banking" 1995). In 1994, International Nederladen Bank (ING Bank of Holland) became the first foreign bank to open two offices in Havana: first, a subsidiary by the same name, and later a 50% owned subsidiary—the Netherlands Caribbean Bank, N.V. from Curaçao—to perform trade finance as well as other banking services.[12] On November 20, 1995, licenses were granted to the Société Générale de France and to Banco Sabadell from Spain (Soberón Valdés 1995, p. 11). Some other banks which have established representative offices in Cuba are Havana International Bank Ltd., the National Bank of Canada, Fransabank S.A.L. of Lebanon, Banco Nacional

11. Although the Cuban government rules out the possibility for foreign banks to open representative branches on the island in the near future, many foreign banks are optimistic that it will happen soon. Plasencia interview; Soberón Valdés (1995, p. 10); "Cuba's Pre-Revolution Banking" 1995.

12. Netherlands Caribbean Bank is 50% owned by ING Bank of Holland and 50% owned by Grupo Acemex, a Cuban shipping company. "Cuba's Pre-Revolution Banking" 1995.

de Comercio Exterior from México, and the Banco Exterior de España and Banco Bilbao de Vizcaya (BBV), both from Spain (BNC 1996, p. 28). Other foreign commercial, investment and merchant banks have expressed interest in opening representative offices on the island.[13]

With scarce credit available to Cuba as a result of the US trade embargo, many foreign financial institutions have begun providing private financing in exchange for conventional bank loans. Some examples are the Guernsey-based Beta Gran Caribe—which will provide capital for trade financing and leasing facilities—as well as the Cayman Islands-based International Financial and Investment Holdings Company Ltd.—which according to a company announcement possesses "substantial expertise in the financial services sector in Cuba" ("New Financing" 1996). Although these foreign institutions have a small capital base and are offering very limited amounts of financing, their presence is helping to fill the credit gap the Cuban financial sector is currently facing. In addition, some of these institutions, as is the case with the Curaçao-based offshore bank created by ING Bank of Holland along with ACEMEX Group's financing institution has guaranteed the Cuban government's access to other banking services such as fund transfers, deposits, currency exchange, letters of credit as well as banking and financial advice.[14] As a Canadian lawyer with business interests in Cuba said recently: "When banks are pulling back and government-supported credits are drying up, offshore merchant banking is increasingly a growth area providing one of the only avenues available for foreigners doing business in Cuba" ("New Financing" 1996).

With the passage of Decree Law No. 165 on June 6, 1996, the possibility for foreign banks to open fully operational branches on the island became very real. This law allowed the establishment of a series of special economic zones (SEZ) in Mariel, Cienfuegos and La Habana.[15] Among its concessions, the law authorized foreign banks to freely operate in these trade zones subject to their respective countries' laws and regulations (Rúa del Llano 1996, p. 7; Plasencia interview; U.S.-Cuba Business Council 1996, p. 8). However, the government has been slow at implementing the law partly due to the complex bureaucracy in the country and partly because the trade embargo obstructs corporations which operate in Cuba from exporting their goods and services to the United States.

Nevertheless, it is unknown at this point to what extent this law will actually help to liberalize Cuba's financial sector. In China, for instance, the SEZs gave freedom to branches of foreign banks to offer specialized financial services that could attract foreign investors. Although these were not allowed to conduct business throughout the whole country, the branches of foreign banks in China were allowed to set interest rates according to the market conditions of the given region in which they operated. In addition, the Chinese government also allowed ITICs to proliferate in these areas. These institutions, as was mentioned earlier, helped to access international funds to promote further foreign investment and economic growth in the country (Mehran et al 1996, pp. 9, 11). Such

13. Recently, however, foreign banks have begun to shy away from the opportunity of establishing representative offices in Cuba. Despite reassurances from the BNC, foreign banks are concerned with Titles I and II of the LIBERTAD Act. Title I prohibits US entities from financing transactions that involve expropriated property. Title II goes further and states that those who engage in a commercial activity that utilizes or benefits from expropriated property will be subject to legal action in the United States. A Canadian banking official said that he interpreted the bill to mean that "a bank supplying services to a trafficker could also be vulnerable to litigation." U.S.-Cuba Business Council (1996, p. 7); *Intervención* (1996, p. 8).

14. Brochure for Acemex Management Company, Ltd., n.d., p. 16.

15. Although Special Economic Zones (SEZ) vary from country to country depending on its legal framework or the economic sectors which they encompass, they are in general defined as geographically determined, tax exempt areas where the government of the host country grants special concessions to selected export-oriented enterprises. These concessions can be in the form of taxes, tariffs, labor regulations and the like. As stated in Caves (1996, pp. 220-221: "[t]he government can thereby relax onerous regulations that it does not wish to repeal outright." See also Mañalich Gálvez (1996, p. 94).

broad financial and economic freedoms led many to proclaim that "[p]arts of China, like the coastal areas, can take the road of free-market authoritarianism."[16]

However, one can safely assume that even when fully operational, the SEZs in Cuba will not be considered such an integral piece for the success of financial reform as they have been in China because of the difference in size between both countries (Mehran et al 1996, pp. 9, 11).[17] The SEZs in Cuba will more likely generate results similar to those achieved by smaller communist nations such as Vietnam. Nevertheless, by allowing the establishment of foreign banks in the SEZs, Cuba will be able to attract greater foreign investment and prepare the local financial sector for the future entrance of these banks in a fully competitive financial environment.

Future Reform

As the last section has demonstrated, the institutional aspects of Cuba's financial sector reform are still in their incipient stages. However, as a result of the crisis of the early 1990s, the Cuban government has been able to establish a blueprint for future reform that will nonetheless allow the financial sector greater freedom at promoting economic growth and development than the monobank system that had preceded it. However, Cuba's financial sector is still afflicted by such grave problems as insufficient capitalization, little or no public confidence and support, excessive segmentation, poor regulation and supervision, a high proportion of bad loans, poor savings instruments, a lack of modern techniques and technology, and inexperienced managers. Thus, if the Cuban government hopes to successfully carry out its economic reform agenda, it will require further institutional change. Coupled with a stronger institutional framework, the establishment of a strict supervisory and enforcement mechanism will help to create an efficient financial sector and a budding enterprise sector with which to prevent economic stagnation and massive social dislocation. Achieving this objective will require the Cuban government to improve its financial infrastructure while implementing further reform in a gradual fashion, taking into account the growing private sector's financial needs. In this way, Cuba may ultimately avoid the fate of the other reform economies, which as Jeffrey Sachs has stated, "succumbed to an extreme financial crisis during the reform period."[18]

RECENT EFFORT AND PROGRESS

One way in which the government has attempted to improve the resource allocation process is through the passage of laws that seek full financial transparency.[19] As McKinnon (1991) has demonstrated, the establishment of a national tax system is a requirement for economic decentralization since tax revenue helps to fill the deficit created by the simultaneous income reduction caused by reduced profit confiscation. Decree Law No. 73, for example, established a national taxation system, which has required many state-owned enterprises to submit income statements for taxation purposes (Pérez interview; Carranza et al

16. Antonio Chiang, a Taiwanese magazine publisher, as quoted in "Chinese Communism" (1996, p A6).

17. Although officials at the BNC have stated otherwise, Carlos Lage has repeatedly stated that Cuba will not allow foreign banks to operate on the island. In a recent speech to the Council of Ministers, Lage (1996) said the following: "This [financial sector reform] is not a matter of bringing in foreign banks to operate in Cuba; there are branches of foreign banks in Cuba which are involved in a sort of promotion of investments or promotion of financing. But the operation of banks in Cuba is the terrain, the province of the Cuban state, which with the restructuring uses, in some cases, private forms of organization, while the ownership is absolutely in the hands of the state." Also, Plasencia interview.

18. Sachs, as quoted in Castañeda and Montalván (1996, p. 1).

19. An area of dispute in the economic study of Cuba is the degree to which the island government has achieved financial transparency. Babún (1996) states: "Unconfirmed reports suggest that BIC may be quite large, with income of about $100 million on revenue of about $2 billion. However, these banks are private companies; hence, it is not possible to obtain financial information on them." As the author will show in this section, Babún is correct in noting that the degree of financial transparency in Cuba is limited. However, recent reform is helping to overcome this problem. BICSA's 1995 Annual Report—audited by the prestigious accounting firm Ernst & Young—states that the firms' total operating income for 1995 was $13 million, growing from $4 million the year before. The bank's total assets amount to approximately $156 million. BICSA (1996).

1995, p. 47). However, the reform stopped short of founding an independent auditing agency, which could have objectively examined the accuracy of these statements. Instead, the Ministry of Finance and Prices has been made the de facto tax collection agency, although it is unknown to what extent they actually ensure compliance with present tax law.

Based on the information I obtained from senior managers of Cuban enterprises, little or no on-site supervision takes place in Cuba. On the contrary, the Ministry of Finance and Prices depends almost solely on bank and enterprise disclosure. Considering the Eastern European experience with bank disclosure, such a practice could open the door to false accounting and tax evasion.[20] For example, in Cuba, failing state enterprises are allowed to deduct their losses, which sometimes perpetuates their poor financial condition despite the continuance of government support via preferential credit and subsidies (Pérez interview). In addition, most Cuban tax examiners do not have adequate loan appraisal capabilities. To the Cuban government's credit, the Ministry of Finance and Prices is painstakingly trying to increase their capabilities so that they may more adequately fulfill their tax collection duties.

Furthermore, the Cuban government claims it is currently improving the country's so-called "financial fundamentals," such as instituting uniform accounting guidelines and procedures. To prove this fact, 1995 was the first year in which Cuba provided the international community with an annual income statement on the BNC's financial strength. For the reader's review, a copy of the income statement has been attached. In addition, the Ministry of Finance and Prices has been put in charge of training financial sector personnel in order to guarantee that they possess the technical skills necessary to administer credit and manage economic information (Soberón Valdés 1995, p. 10). As Francisco Soberón Valdés—the President of the BNC—recently told foreign investors, the problem is as follows:

> We are in the complex process of redefining our entire enterprise sector. Our system of payment orders is deficient, and does not allow a dynamic flow of financial transfers across all sectors of the economy. Our entrepreneurial accounting procedures are also deficient and we are undertaking a huge effort of instituting a uniform and accurate accounting system based on recognized and established international standards. We are also in the process of restructuring and automating our banking system (*Intervención* 1996).

Based on Calvo et al. (1993, p. 10), these changes should constitute a positive first step towards the better macroeconomic management of the economy since they will help Cuban banks to objectively assess both the borrower's creditworthiness and the investment risk behind a given venture. In addition, the reform will reduce the unnecessary burden currently placed upon foreign investors of having to reconcile Cuba's system of payment orders with Western-style banking. These reforms are expected to create a banking system that operates under globally recognized accounting rules and procedures (Triana Cordoví interview).

Increased financial transparency, however, will also require stronger supervision and enforcement mechanisms to guarantee compliance with the law. For example, one may assume that the successful implementation of Cuba's auditing mechanisms and tax structure will largely depend on ensuring the compliance of the newly independent financial institutions and state enterprises managed by the Ministry of the Armed Forces (MINFAR, from its Spanish name, *Ministerio de las Fuerzas Armadas Revolucionarias*), since their influence and power in Cuban economic activity is significant. As such, securing the MINFAR's compliance with this system would probably assure the compliance of non-MINFAR managed state enterprises as well.[21] Although the enforcement

20. Eastern Europe's reform experience has demonstrated that weak accounting rules and poor supervision disguise the quality of loan portfolios, which allows enterprises to have apparent profits and pay taxes despite their true situation. Roe (1995, pp. 15, 18, 26).

21. For an extensive review of the MINFAR's influence over Cuba's economic activities, see Pérez-López (1995a), Mesa-Lago (1994) and Amuchastegui (1995, p. 5).

of rules is obstructed by the inexperience of the regulators who created them, compliance can also be achieved by granting strong enforcement powers to the CBC's supervisors to remove managers and to allow fresh capital injections, as well as by using external auditors to complement the Ministry of Finance and Prices internal staff (Roe 1995, p 38).

Improving Financial Sector Efficiency

In Cuba, most equipment used for effecting financial transactions is Eastern European or Soviet for which replacement parts are no longer available. As a result, Cuba's financial sector now possesses a backwards and outdated infrastructure, and is in desperate need of modernization. However, the Cuban government has already begun to pursue a massive effort towards modernizing its financial infrastructure. As Soberón Valdés (1995, p. 12) has indicated: "We are undertaking a massive effort to modernize the operational efficiency of our banking system by installing computers and by linking its branches via an electronic network of data transfer. This effort is taking place at a rapid pace." In addition, since banking personnel lack the skills to engage in specialized financial transactions, the Cuban government is seeking to improve the professional and technical capacity of its staff (Triana Cordoví interview).

Currently, Cuba's banking staff is well-qualified by international standards. Most of the NBS's employees have accounting and economics degrees. However, with exception of the recent-graduates that studied under the special University of Havana-sponsored MBA program, most lack the knowledge and necessary skills to provide specialized financial services for a market-oriented socialist system.[22] Thus, Cuba faces the arduous task of training and developing the managers, bankers, accountants, auditors and financial analysts of the future; those that will effectively manage the complex activities of the NBS and who will be responsible for ensuring its long-term credibility.[23] At year end 1995, 85 specialists had been trained. By 1996, the government expects to have trained 350 more (BNC 1996, p. 27). However, how do you change an educated population's mindset quickly enough to absorb the sudden changes occurring as a result of the country's current financial reform? As the Cuban government is learning, this transformation is a difficult one since it includes changing the Cuban people's attitude towards risk and the acceptance of responsibility. Such are the challenges the legacy of central planning is posing to Cuba's economic development.[24]

Besides seeking to improve its organizational capacity, the BNC is also attempting to improve the speed of its payments system via an ambitious modernization program (Echevarría Vallejo 1996, p. 17; Mehran et al 1996, pp. 38-39). Lage (1996) stated in a speech to the Council of Ministers that by the end of

22. "To change the mind-set, Havana University has launched an MBA program. Its first 50-member class, which graduated in February, was chosen from 800 applicants. The courses range from accounting to foreign trade. But there are ideological ironies. Gripes one MBA student: 'I am studying about investing capital when Cubans cannot invest in Cuba. If you are a foreigner abroad, you can invest. But if you are a Cuban, no." DeGeorge (1997, p. 50).

23. According to Pérez-López (1994, p. 295), "[w]hat thirty-odd years of socialism have done, however, is to erode market-oriented skills of managers, accountants, auditors, etc." Travieso-Díaz and Escobar (1995) argue that Cuba is ill-prepared to handle the growing demands of a decentralized economy, lacking even the legal professionals required to regulate it. While Luis Salas reports that there were only 700 professional judges in Cuba in 1991, Czechoslovakia—a country of comparable population—had about 1,600 at the start of their transition in 1989. Thus, according to Travieso-Díaz and Escobar (1985, p. 384), currently the "[l]aw practice in Cuba is constrained not only by the inadequate number and qualifications of the legal professionals, but also by the judiciary's lack of independence, the prohibition against the private practice of law, and the expectation that defense counsel in criminal cases will put the interests of the state before those of their clients."

24. Soberón Valdés (1995, p. 10) said that the island currently lacks the skilled personnel to perform specialized financial services, but that the Cuban people have the educational base and the willingness to learn quickly. Also Triana Cordoví and Plasencia interviews. However, Murrell and Wang dispute his optimism; as quoted in Pérez-López (1994, p. 295) they say that: "The ability to function efficiently within a particular set of market institutions comes about as a result of market activity rather than being endowed or learned quickly through formal education. Therefore the lack of market institutions under communism leads to a dearth of both market-oriented human skills and organizations that can function in the market environment."

June 1996, the Cuban government expected to have automated 303 banking units and have installed 5, 000 computers in the country. According to the government, the BPA's 500 branches are currently being modernized as well (EIU 1996-97, p. 32). The government expected to have modernized 71% of its branches by year end 1996, and to have installed 8, 000 computers in all of its 700 banking branches throughout the island by year end 1997. The results of this program are yet to be seen (Lage 1996; BNC 1996, p. 27). However, the need for modernization is evident from the photographs on the following page, which demonstrate that while banks that cater to foreign investors such as BICSA and the Banco Metropolitano, S.A. already have state-of-the art equipment, the BNC and the BPA continue to perform its financial transactions in a manual fashion.[25]

Given the difficulties in purchasing U.S.-manufactured equipment and after surveying several branches of the BNC in Pinar del Río and Havana, I am skeptical that the government's modernization program is pursuing as quickly as it claims. Nevertheless, upon completing the modernization drive, the Cuban government should have finished installing an extensive banking network via computerized links from its branches to a national data center in Havana (BNC 1996, p. 27). This change by itself will result in dramatic increases in the efficiency of financial transactions versus what had existed during the pre-reform monobank dominated system.

STRENGTHENING THE FINANCIAL SECTOR TO FUEL FUTURE ECONOMIC GROWTH

As we have seen, the Cuban government is tackling important challenges by undertaking financial sector reform while engaging in a difficult economic transformation. In the financial realm, the government's new economic development strategy has sought to reform the monobank system in order to create a more efficient and financially strong banking system that can effectively channel credit to the most strategically important and productive sectors of the economy. To accomplish this goal, the Cuban government will continue engaging in budgetary restraint by further reducing subsidies, streamlining enterprises, and providing a more active role for the financial sector to attract capital and foster investment on the island (Soberón Valdés 1995, p. 8; Echevarría Vallejo 1996, p. 18). Therefore, the Cuban government will need to continue deregulating and decentralizing the economy, while enforcing tighter rules to govern its banks and state-owned enterprises.

To fulfill this objective, it is imperative that the Cuban government establish a strong CBC as quickly as possible so that it can effectively implement monetary policy in order to facilitate the macroeconomic regulation of the economy (Soberón Valdés 1995, p. 7). As such, its focus will need to be achieving capital adequacy, fully establishing uniform accounting guidelines and procedures, limiting large exposure in the banking system's loan portfolios, and ensuring the effectiveness of its supervisory and enforcement powers, while inhibiting itself from intervening in situations of enterprise or bank failure (Roe 1995, p. 16). Considering the challenges that lie ahead, I have included some institutional recommendations which the Cuban government should consider while engaging in financial sector reform:

- *Demonopolization.* The Cuban government has already partially demonopolized its tourism sector. Nevertheless, most of the country's other strategic economic sectors continue to be dominated by one or two large industrial interests. This situation needs to be changed to allow greater competition within these sectors, including the banking sector (Dunning 1993, pp. 336-339).

- *A legal framework which prohibits state banks from lending to state enterprises.* State enterprises should gradually become subjected to a system of self-financing, while the emerging private sector

25. "Cuba Opens" (1996). In addition, BICSA is already connected to an international consortia of firms founded in 1973 called the Society for Worldwide Inter-bank Financial Telecommunication (SWIFT), which has established an international clearing system for the banking sector. See Dunning (1993, p. 271); Mulet interview.

should be given greater access to available credit (McKinnon 1991).

- *Establishment and subsequent enforcement of laws that prevent predatory pricing and unfair competition.* This legal framework and its compliance will just help to encourage the development of the independent NBS and the emerging private sector, which will in turn allow the economic reform process to take root.

- *The formation of private capital markets similar to the agropecuario markets, wherein private enterprises and cooperatives can access credit.* This policy will help to create independent financial intermediaries as well as small private commercial banks. However, strict regulation and supervision will be required to prevent the formation of credit cartels and intimidation via high interest payments. These markets should provide a sorting mechanism for "young" private enterprises as well as a method by which the Cuban government can better understand the true size of real interest rates in the economy.

- *Finally, to increase credit access in the economy as a whole, further financial reform needs to eradicate the segmentation of household savings.* By doing so, implementation of a personal income tax will help to reduce consumption levels and increase government revenue for investment.[26]

However, these recommendations by themselves will not improve the resource allocation process nor the flow of financial transactions within the Cuban economy. Instead, these recommendations will require a strong, but flexible regulatory and supervisory framework that can quickly adapt to the changing realities of the emerging private sector. In this way, a reform government can exercise sound judgment to correct market failures as they occur, in order to maximize long-term economic output and profitability.

Moreover, institution-building becomes one of the most important steps for achieving such development, since without it there can be no regulatory mechanism with which to safeguard the emerging private sector. This process, however, needs to reflect the country's culture and history, as well as its already existing institutional framework. It is very convenient for skeptics to recommend that Cuba privatize all of its state property to foreign interests and adopt a Western-style institutional framework with which to regulate the nascent market-economy.[27] Their argument usually relies on the economic efficiency achieved by such market economies as Japan and the United States.[28] However, the reality is that these global economic powers did not build their institutional frameworks overnight, but rather did so over many decades, creating new regulations depending on the particular set of internal and external circumstances that prevailed at the time. Thus, Cuba needs to continue pursuing a strategy of gradual financial sector reform, whereby as the private market grows and strengthens, the institutional framework changes to accommodate to the needs of its economic actors.

According to BICSA (1996, p. 10), signs of further reform continue emerging. The Cuban government, for the first time since the onset of the Revolution, has a firm commitment to decentralizing financial activity to help continue fostering the country's economic growth and development. Besides the creation of the CBC in the next few months, the Cuban government plans to continue creating new specialized

26. Pérez-López (1994, p. 296). For a more in-depth discussion of pro-competitive policies, see Dunning (1993).

27. Pérez-López (1994, p. 296) argues that "a thriving market economy does not emerge spontaneously as a result of 'letting capitalism happen': it requires a special set of institutional arrangements that most countries in the world do not have. Moreover, he argues (p. 299) that "[c]are must be exercised not do away with the noxious socialist institutions until replacement institutions that support and nurture the market are in place."

28. The author makes reference to the works of Carlos Fernández, Raúl M. Shelton, Fernando A. Capablanca and Jorge Salazar-Carrillo, all of which seem to advocate a radical eradication of existing socialist institutions and their subsequent replacement with Western-style institutional frameworks. All of these works were included in *Cuba in Transition—Volume 4* (Washington: Association for the Study of the Cuban Economy, 1994).

financial institutions and licensing more foreign financial entities to establish representative offices on the island. This further decentralization—coupled with lessened market segmentation—will expand Cuba's current institutional environment and lead to greater competition and efficiency in the economy as a whole. Finally, the sector's continued modernization will help establish a strong regulatory and supervisory framework that ensures fair and efficient credit allocation as well as promotes productive economic activities throughout the island.

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