COMMENTS ON

"Cuba: Cooperación Internacional de Emergencia y para la Recuperación" by Castañeda and Montalván

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There are many things in this paper that I agree with, particularly as regards the broad economic strategy. For example, I agree that international cooperation in Cuba's transition should help to create the condition for private investment, both Cuban and foreign; that private foreign investment flows should exceed flows of official development assistance by a wide margin; and that the engine of recovery of the Cuban economy must be the private sector. I am happy that we agree on these rather basic things because there are a number of more specific, but nevertheless important points of economic policy on which I disagree. In several cases the disagreements reflect the authors' misunderstanding of the experience of transition in other former communist countries. I will mention five points.

First, the authors are right in that a substantial monetary overhang probably remains in Cuba in spite of the government's restrictive monetary/fiscal policy in 1994-95 and the relatively high inflation in free and black markets during those years. The authors state that the solution to this problem is "a coherent package of monetary reform" (I am not sure exactly what that means) and the establishment of a fixed exchange rate *vis-a-vis* the dollar (that may or may not be desirable, but it is not clear how it is going to absorb the excess demand for money). I think it is important to be clear on this point: the only sure way to get rid of the overhang—and at the same time to eliminate a major source of resource misallocation—is to eliminate price controls. The experience of Eastern Europe and the former Soviet Union strongly suggests that price liberalization leads only to a *temporary* (and unavoidable) jump in the price level, and *not* to a sustained inflationary process; and that much is to be gained by liberalizing fully and as soon as possible. Therefore, a recommendation to stabilize first and then only to "initiate a gradual process of liberalization" is, I believe, an invitation to waste precious time.

Second, there is another lesson from the transition in other centrally planned economies that the authors should bear in mind: what they call a "monetary shock"—by which, I assume, they mean the tight monetary policy implemented by certain countries in transition to avoid hyper-inflation—is *not* the cause of the recession suffered by many of these countries. I believe I have shown in a recent paper[1] that such a recession is mostly the result of the overriding need to restructure the hopelessly inadequate economy inherited from the old regime and to replace the output of socialist junk goods by the production of goods and services that people want to buy freely. In fact, the overwhelming empirical evidence indicates that the

1. "Liberalization and the Behavior of Output In the Transition from Plan to Market," in this volume.

countries that ran a tough anti-inflationary policy from the start, like the Czech and Slovak Republics, Poland, Estonia and Latvia, have been the first ones to come out of the recession and are now experiencing above-average output growth. Those that chose to disregard the need for a disciplined monetary policy like Ukraine and Belarus, are now paying the price.

Third, for the reasons I just mentioned, I take exception to the suggestion that under-utilization of existing capacity in the state sector is "unnecessary," or that it justifies in any way the adoption of a "Chinese" or "Vietnamese" model, as opposed to an "Eastern European" model. The reason why China and Vietnam avoided a period of output decline after the beginning of reforms is that their industrial sectors were very small compared to those in most Central, Eastern European or former Soviet states, and that China and Vietnam aggressively liberalized their large agricultural sectors (contrary, for example, to what was done in Russia and Ukraine).[2] I would add one important fact: in Russia, in the Baltic countries and in most of the countries of Central and Eastern Europe you can now vote freely for the candidate of your choice and you can criticize the government as strongly as you wish.

Fourth, Castañeda and Montalván write that "the success of stabilization can be determined by a an annual inflation rate of 30% to 40%." This I find extraordinarily unambitious by the standard of this region. Consumer price inflation this year is running below 20% in virtually all the countries of the Western Hemisphere with the notable exception of Venezuela. And in most of the major countries of the region, including Argentina, Brazil, Canada, Chile, Perú and the United States, inflation is in the single digits. What I find difficult to understand is how

ceed in maintaining a "competitive real exchange rate" as the authors recommend.

Fifth, perhaps the answer to the puzzle is the authors statement in the paper that there should be an initial devaluation large enough to ensure initial competitiveness and that the exchange rate will then be "adjusted gradually" to allow "a sustained expansion of exports." But if we have learned one lesson from the currency crisis in Mexico, the Czech Republic, the Philippines, and more recently Thailand, it is that once they are on a fixed exchange rate, the authorities tend to fall asleep until the crisis comes. In the words of Carmen Reinhart, fixed exchange rate systems (and their close cousins like *tablitas*) carry in themselves the seeds of their own destruction, because as soon as they are announced speculators anticipate the sequence of real exchange rate appreciation and mounting current account deficits and, at the first opportunity, they attack the currency. This is not what Cuba's new central bank will need at a time when its reserves probably will be exhausted.

A fixed exchange rate at the beginning of the transition is much too dangerous. Cuba should float until the peso finds its proper level in foreign exchange markets. Then, there is room for a serious debate on exchange rate policy in the longer term—on whether Cuba (like Canada) could maintain a stable relation between its currency and the dollar without surrendering its ability to adjust the exchange rate when its competitive position is threatened by asymmetric shocks, or whether it should peg to the U.S. dollar (like the Bahamas and other tourist-based Caribbean economies). But the authors do not see it that way. They state that exchange rate floating "should not be tolerated," and they go on to say—to end on a surrealistic note—that neither should the "free entry and exit of short term capital nor very high real interest rates be tolerated." This is a rather remarkable state-