FELIPE PAZOS ON CUBA'S TRANSITION: 10 YEARS LATER

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Ten years ago, Felipe Pazos gave us a valuable tool to help us think about the economic problems of transition in Cuba. Recently I re-read his paper "Problemas económicos de Cuba en el periodo de transición" and asked myself how it had withheld the test of time, focusing particularly on macroeconomic issues and policies.

Early in his article Felipe Pazos listed some of the key problems that policy makers in Cuba would have to confront "at the time of the change." Those of particular relevance to the macro area included:

- The conversion of the state economy into a market economy.
- The need to cope with a low level of income and high fiscal and external deficits.
- The realignment of prices with costs.
- The problem of inflation.
- The need to attract private capital.

Looking at this list, I had the uneasy feeling that something was a little wrong. The "change" that Pazos was referring to—a political regime change—clearly had not taken place. Castro was still very much in power. And yet, some of the problems in the list appear to have been addressed, at least in part. For example, Pazos had stated, "when the change takes place, Cuba will be in a critical situation, with a low level of income, large fiscal and external deficits resulting form the cumulative effects of three decades of communist inefficiency…" That does not quite seem to describe the economic situation in Cuba now.

But the feeling of unease disappeared when I realized that this description fit perfectly with the situation prevailing in Cuba just before the reforms initiated in late 1993 and in 1994: the fiscal deficit peaked at 30 percent of GDP in 1993, inflation in informal markets exceeded 200 percent, the peso was crumbling against the dollar in the parallel market, the monetary overhang was mounting, and rationing had intensified dramatically. The cumulative drop in GDP from 1991 to 1993 was roughly 40 percent—Pazos had guessed 20 or 30 percent, close enough. The problems that Pazos had identified as crucial were indeed the right ones! And they had become so dramatic, so quickly, that by the end of 1993 the overriding need for reform and macroeconomic stabilization to avoid a complete collapse of the Cuban economy had become clear to any serious analyst of the economy.

What Pazos did not predict—and I don't know anyone else who did—was that action in response to the urgent need for stabilization and liberalization was taken not by a *new* government, politically committed to a full transition towards a market economy, but by the ruling communist government itself. To be sure, it would have been very difficult for someone writing in 1991 to forecast an economic situation serious enough that some in Castro's entourage would have the courage, or the desperation, to tell Castro that things were very bad. So bad that his choice was between stabilization and at least a degree of economic liberalization, or continued disintegration of the economy with a real prospect of mass hunger and political upheaval. It would have been even more difficult to forecast that Castro would listen and allow the "reformists" to act.

In the event, Castro did listen, perhaps because he realized intuitively that the economy was approaching a dangerous zone, and, reluctantly, he allowed the "reformists" in the government to act. But what he allowed was a mixed bag: audacious in the area of macro-stabilization, partial and reluctant in the structural area. On the stabilization front, adjustment was as rigorous as the most rigorous IMF program could have hoped for. The state's fiscal deficit dropped in relation to GDP from 30 percent in 1993 to 7.5 percent in 1994 and to 2 percent in 1997. And since much of the deficit had been financed by central bank credit, monetary expansion and inflation stopped abruptly; indeed, in 1994 both the money stock and the level of free market prices actually fell, and the peso appreciated against the dollar in the parallel market. Just what Pazos would have prescribed.

What about the external deficits? Pazos thought they also would be large and problematic following the end of Soviet assistance. Well, they certainly were problematic, but they were not particularly large. In fact, the current account deficit fell in relation to GDP from 14.4 percent in 1989 to 2.6 percent in 1992, and then ranged between 1 and 2 percent through 1998. The fact is that after the end of the Soviet subsidies, Cuba could not afford to sustain huge current account deficits; these deficits had to be financed, and Cuba did not have access to official lending—bilateral or multilateral—and its access to the Russian taxpayer had just been shut off. The pressure eased after 1994 with the growing inflows of dollar remittances, but the government decided to use the room for maneuver provided by this lucky break to service part of Cuba's external debt.

We know the story on the structural side: decriminalization of the possession and use of the dollar, redistribution of land towards the non-state sector and creation of free agricultural markets, and legalization of self-employment—but with severe and unnecessary regulatory limits, and later with crippling taxation. And, of course, no privatization of state industrial assets. Altogether, employment in the private sector rose from almost nothing in 1993 to 19 percent of total employment in 1994. That was a remarkable increase; but the private employment share appears to have leveled off at about 25 percent, and that is a dismally low level compared, for example, to China's 70 percent or Hungary's 75 percent.

In sum, the Cuban authorities in 1993-94 acted on all the key macroeconomic problems singled out by Pazos in 1991. They went in the right direction everywhere, and probably avoided a very serious crisis. But, on the structural side they stopped far short of full liberalization—probably because of the political power's visceral distaste for economic freedom.

Felipe Pazos correctly anticipated that the end of Soviet assistance would give rise to an unsustainable situation. Understandably, he assumed that the transition would be associated with the fall of Castro's regime, and on that score he was wrong. But he rightly stressed the key point: "the problems and the policies of the transition," he wrote in his 1991 paper, "will be similar irrespective of the circumstances in which they occur." In the end, Cuba may go through two transitions: the first took place in 1993-94 and emphasized macroeconomic adjustment; the second, still in the future, will have to feature full price, exchange rate and labor market deregulation, and full privatization of state assets—and that transition will have to be implemented by a political power committed to a free market economy as a new way of life. Which does not mean that policy makers will not have to worry about the macro side: when financing difficulties strike—and they will at some point, no matter who is in power—the temptation of inflationary finance will reappear, and it will have to be resisted. Felipe Pazos will no longer be there to guide our hands, but his work on transition, like his work on inflation and central banking before that, will continue to be the guiding light.