CUBAN MONETARY UNIFICATION: ZEROING IN ON WHY THERE HAS BEEN ZERO DAY ZERO IN CUBA

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In October 2013, the Cuban government announced the beginning of a monetary unification process aimed at redressing one of the greatest distortions in the island's economy. This unification process was to take place in phases and build towards its final stage, the "Día Zero" ("Day Zero"), the day when the Cuban Convertible Peso (CUC) would disappear and the authentic Cuban Peso (CUP) would rise as the only national currency. Although Cuban authorities did not announce a specific unification road map or time line, the national and international consensus was that the countdown for the disappearance of the CUC had started. Since the unification of the dual monetary system is seen as a necessary condition for a genuine economic transition to take place, the official herald of the imminent currency unification was welcomed and widely celebrated.

Two years later, the initial enthusiasm regarding the impending unification of the currencies has melted away. So far, the currency unification process has followed a strange path, taking one step forward and several steps backward. Rumors about the setting the date of Day Zero often circulate, but the CUC refuses to leave the stage.

Some of the pundits who predicted a swift end of the monetary dualism have expressed their disappointment with the lengthy and endless game being played[1]. However, besides concerns about timing and the lack of a defined path towards unification, there are many other questions that the delay in launching the unification process bring to mind. What is the real reason standing in the way of monetary unification in Cuba? Are the weak fundamentals of the Cuban economy, as economists in the island usually argue, the main reason for the delay? Will Day Zero ever really happen?

The above questions suggest that perhaps the most crucial unknown is whether monetary dualism (dollarization) is indeed the source of the many drags on the Cuban economy, and therefore, whether the Cuban government feels truly compelled to dismantle a system that has yielded so many economic and political benefits. A careful examination of the Cuban economy reveals that the great expectations regarding the positive economic impact of unification and the commitment of the government to the process are exaggerated.

In this paper, we address the above issue indirectly by taking a look at earlier debates regarding the topic of dollarization in Cuba. We provide alternative explanations on the main arguments wielded by experts who advocate the dismantling of the dual currency regime. We review some of our previous work on this topic[2], as well as papers by Moreno[3] and Sanguinet-

1. In an interview with Roberto Veiga, Pavel Vidal accepted that: "Todos los que vaticinábamos que el "día cero" para el comienzo de la reforma monetaria sería en enero de 2015, nos quedamos esperando." Cuba y Economia blog, May 13, 2015.

2. Kildegaard, Arne and Orro, Roberto (1999), "Dollarization in Cuba and Implications for the Future Transition", *Cuba in Transition—Volume 9*; Orro, Roberto (2008), "The Cuban Dual Monetary System and Challenges Ahead", *Cuba in Transition—Volume 18.*

ty[4]. The latter in particular asserted correctly that monetary dualism would be a vehicle for Cuba´s transition towards a market economy. We conclude that the positive expectations regarding monetary unification rely on a misreading of the Cuban reality. Dollarization is the visible face of the structural flaws of the Cuban economy; it is the effect of the problems, not their cause.

In addition, we link the monetary issue to the ongoing process of political succession in Cuba, a process that has nurtured powerful economic interests and will likely survive and consolidate under any future scenario. Moreover, in light of recent international events, that in the best case are not a windfall for the Cuban economy, we predict that the Cuban government will tighten the grip on hard currency reserves, pushing farther into the future the long awaited monetary unification.

The paper is structured as follows. First, we review the main arguments in favor of monetary unification in order to demonstrate that a number of the assumptions underlying the arguments of unification advocates are flawed. Then, we review the prospects for unification, or de-dollarization, and we suggest different monetary policy scenarios that take into consideration the broader economic and political context of Cuba.

FALLACIES AND WRONG ASSUMPTIONS ON MONETARY DUALISM IN CUBA

Monetary dualism or dollarization in Cuba is a topic that has received wide attention by economists and analysts worldwide. The Cuban case stands out as unusual example of dualism that poses a riddle for many experts.

Cuban as well as foreign economists have written on this topic. Predicting the political and economic future of Cuba, monetary policy included, is a challenging exercise subject to a high margin of error. Nonetheless, we believe that Cuban economists have not always presented accurately the historical background of monetary dualism/dollarization in Cuba. A constructive review of these arguments will help in developing a better understanding and will lay the ground for more realistic conclusions.

Monetary Dualism Introduced Economic Distortions

My main objection to this proposition centers on the use of the word "introduce". If it were true, we would have to conclude that Cuba had a more efficient monetary system during the 80s, during the cusp of the use of central planning and the honeymoon with the Soviet Union.

Arguing that the dollarization of the early 1990s introduced distortions is a fallacy that ignores that Cuban policy markers operated for nearly 30 years nearly blindfolded, plagued by numerous distortions related to the inconvertibility of the national currency. The artificial exchange rate of one peso equivalent to one U.S. dollar was not an invention in the early 1990s; it has stood for five decades. Even worse, the exchange rate labyrinth was complicated by the barter relations with the countries of the Council for Mutual Economic Assistance (COMECON). The economy worked erratically, misguided by a perverse set of signals emerging from a cocktail of Soviet subsidies, arbitrary decisions and weak links to free market economies.[5]

Dollarization started in the early 1990s and ended in 2004, when the Cuban government banned the use of the U.S. dollar. Monetary dualism did not start in 1993. What happened that year was that the Cuban government legalized the holding and use of U.S. dollars by ordinary Cuban citizens.

3. Moreno Villalaz, Juan Luis (1992), "Una Política o un Sistema Monetario Óptimo", *Cuba in Transition—Volume 2.*

4. Sanguinetty, Jorge (1994), "Monetary Dualism as an Instrument Towards a Market Economy: The Cuban Case," *Cuba in Transition—Volume 4.*

5. During my years as a student of Economics at the University of Havana, some of my classmates and I tried to find answers for questions such as: how to determine the right output the sugar industry should produce, how to measure the real profitability of a given firm absent a convertible currency, how could a firm with high levels of imported inputs be profitable in CUPs at the one-to-one exchange rate?

Vidal and Pérez (2013) state that: "La dualidad monetaria comenzó con la dolarización parcial en los años noventa vinculada a la crisis económica, los desequilibrios, la inflación y la depreciación del tipo de cambio".[6] However, Aurelio Alonso, a sociologist rather than an economist, provides a better explanation on the historic background of dollarization in Cuba:

> Nuestros economistas suelen plantear que la dualidad empezó en 1993, cuando se despenalizó el dólar… Sí y no, porque ya existía una diferencia establecida entre la macroeconomía del país, con la que se insertaba en el mercado mundial y en el CAME, donde el dólar se seguía evaluando como equivalente del peso, y el rublo también como equivalente del peso, y la economía interna, donde la moneda nacional no era convertible y no había equivalencia, se había convertido en un certificado, en una moneda interior[7].

Cuba did not pioneer monetary dualism in the socialist community. The Soviets had their own version. The Soviet Union had a separate state-run retail network (*berioskas*) that sold to a restricted clientele, only for hard currencies, goods unavailable in regular stores. East Germany similarly had *Intershop*, state-owned stores that served government officials, party members and foreigners. Only these special groups were allowed to purchase goods at those stores.

Monetary dualism is the mirror image of economic duality, an inherent feature of most centralized economies. Political leaders in socialist countries, Cuba included, were always aware that their economies were plagued by flaws and lacked convertible currencies. This fueled a perverse vicious cycle, a kind of the chicken or the egg problem: top leaders did not trust their non-convertible currencies, but this lack of confidence aggravated the non-convertibility problem, since it begot and propelled a parallel economy.[8]

Cuba, like the rest of socialist countries, suffered a plethora of distortions due to the lack of a convertible currency. There was always exchange dualism in Cuba: one CUP/one U.S. dollar for official accounting and an exchange rate in the black market that fluctuated from five CUP/U.S. dollar, during the 1980s, soaring to 120 CUP/U.S. dollar during the darkest days of the Special Period in the early 1990s.

Monetary/Exchange Dualism Curbs the Integration between Foreign Firms and Local Producers

The title of this sub-section is an assertion commonly added to any statement advocating unification. Proponents of this assertion correctly refer to the messy environment featuring several exchange rates, a kind of riddle for foreign investors.

However, the assertion assumes implicitly, and erroneously, that absent the monetary maze and the multiple exchange system, foreign investors would have an easy path to invest in Cuba. In fact, independent of the disturbing monetary issue, Cuba remains a country with severe restrictions and limited access for foreign companies. No company has unrestricted entry to Cuba; only those that are invited can have a relatively easy path. In order words, monetary dualism is not the root cause constraint dragging on foreign investment in Cuba.

The truth is that most dynamic sectors of the Cuban economy are part of the dollarized economy. Hidalgo and Doimeadiós (2003) underline the positive effect of dollarization in linking the Cuban economy with the rest of the world:

> El dólar fue el principal vehículo para conectar a la economía con referentes internacionales de precios y costos, y de esta forma permitió desarrollar los mercados. Las empresas del sector emergente elevaron

6. Vidal Alejandro, Pavel and Pérez Villanueva, Everleny (2013) "La reforma monetaria en Cuba hasta el 2016: entre gradualidad y big bang", Brookings Institution, Washington, D.C.

7. Aurelio Alonso, *Cubadebate*, December 30, 2013.

8. Vidal and Pérez (2013) acknowledge that monetary dualism is not the core of economic inefficiency in Cuba. "La dualidad monetaria más bien ha servido para esconder las verdaderas causas estructurales de los bajos salarios estatales y las diferencias de ingresos, las cuales están asociadas a la baja productividad y la ineficiencia del sector empresarial estatal".

> los niveles de eficiencia y competitividad, mostrando un fuerte dinamismo económico.[9]

Under the Foreign Investment Law of 2014, as well as the prior regulatory framework, foreign investors are entitled to receive revenues (payments for inputs used by the investment, profits, repatriation of capital) generated by their investments in hard currencies. They are shielded against exchange risks. The elimination of the CUC is not likely to encourage foreign investors to accept contracts and payments in CUPs. Thus, monetary unification will not by itself lure more foreign investors to Cuba, and the segmentation between the CUP and hard currency economies in Cuba will persist and probably deepen.

Let's assume that Cuba allows local private farmers to work with or enter into joint ventures with foreign firms. Under the current economic environment, with food products increasingly sold in CUCs, local farmers would be happy to get loans in CUCs and enter into agreements with foreign partners with revenues denominated in CUCs.

In a related context, it is commonly asserted that the multi-currency system damages the export sector and benefits importers by providing a favorable exchange rate. This is another fallacy. First of all, no local importer has ready access to hard currencies. The mirage of a one-to-one exchange has not driven import decisions in Cuba. Yes, many of those transactions are recorded in national accounts based on the one-to-one (parity) exchange rate, but the imports are not driven by profits, but rather by social and political considerations. For example, this is the case for the allocation of imported goods for health care, education and other social services.

Monetary Dualism Hampers Cuban Exports and Led to the Downfall of the Sugar Industry[10]

This assertion would work only if importers enjoyed a preferential exchange rate to buy hard currencies with Cuban pesos. In fact, most imported goods end up in the non-subsidized retail network and are distributed by outlets controlled by the military holding. The importers do not enjoy a special rate nor do they have free access to hard currencies. Quite the contrary, many importers or retail firms are a source of hard-currency cash that the Cuban government usually takes.

Monetary dualism is not accountable either for the dismal situation of the formerly mighty Cuban sugar industry. Had the government opened the sugar industry, and the agricultural sector as well, to foreign investment, as it has done with tourism, nickel and (more recently) ports, the industry would have retained its competitive edge. The historical data clearly shows that the sugar sector struggled with a traumatic transition after the end of the Soviet subsidies. During the early 2000s, sugar output had stabilized around 4 million tons yearly. The leadership, emboldened by the financial support from Venezuela, decided to abandon the sugar industry and let it fade away, a decision that Cuban economists have strongly criticized. Now, the Cuban government is trying to reverse the policy, but a lot of damage has been done.

Monetary Dualism Has Turned Cuba into an Inegalitarian Society

This is another fallacy. First of all, Cuba has never been a society free of social disparities, even from 1959 to 1993. During that period, top officials enjoyed privileges unthinkable for the common Cuban people. These officials were the only ones with access to highly coveted products from the U.S., Western Europe and even Latin America. However, this was a very small elite, whose consumption patterns were unknown to most ordinary Cubans.

Access to U.S. dollars and other convertible currencies makes the difference in Cuba today. Consumption levels and living standards depend on the amount of hard currency or CUCs that a Cuban family receives. The legalization of U.S. dollars in 1993 cut the traditional link between economic pros-

9. Hidalgo, Vilma and Doimeadiós, Yaima (2003), "Dualidad Monetaria en Cuba: Causas e Implicaciones de Política Económica," *Gestión en el Tercer Milenio*. Universidad de San Marcos en Lima.

10. De la Torre, Agusto and Ize, Allan (2014), "La Unificación del Tipo de Cambio: El Caso Cubano", *Cuba in Transition—Volume 24*.

perity and political loyalty. Since then, the number of people with access to foreign currency, and therefore, the ability to shop in the non-subsidized hard currency market, has steadily grown. Now, social differences are more visible than before, but this is not the same as saying that Cubans were better during the 1980s. Furthermore, more Cubans are aware that having a single currency is not the magical solution to their many shortages.

Dollarization Ended in 2004, when the Cuban Government Banned the Circulation of the U.S. Dollar

Instead of ending dollarization, the CUC takeover in 2004 was meant to protect the balances in U.S. dollars that the Cuban government held, by limiting the circulation of U.S. dollars outside of the government's control, making it more difficult to use U.S. dollars for transactions and to send them out of the country. Pulling back the U.S. dollar was a deliberate measure intended to give the authorities more degrees of freedom and fuller control over hard currency reserves. In addition, the CUC gave some taxation edge to the Government, something otherwise impossible under the previous scenario of two currencies, the CUP and the U.S. dollar.

Of course, the increasing liquidity of the CUC has eroded, but not eliminated, the power of the Cuban government to tax foreign currency exchanges. Black market traders, whose number was significantly reduced after 1994, are back in center stage. Foreigners and visitors can get better rates for their dollars and Euros in the black market. Illegal operations are the only way left for Cubans to buy U.S. dollars.

By repeatedly announcing an impending currency unification, Cuban authorities have struck fear into CUC holders, and encouraged them to tilt their portfolios to get rid of CUCs and instead accumulated CUPs, which is consistent with the interest of the Cuban government in returning to the CUC some of its lost power.

The CUC is weaker but not worn out. It remains as a useful instrument for the Cuban government in handling exchange operations and keeping its grip on foreign currency reserves.

Monetary Unification is a Top Priority of the Cuban Government

If anything has been demonstrated by the Cuban government over nearly six decades in power, it is that it does not hesitate in undertaking the measures and policies that it believes convenient and necessary for its subsistence. Whether changing the national currency overnight, as it did in 1961, installing nuclear missiles as it did in 1962, legalizing the U.S. dollar in 1993 and taking it out of circulation in 2004, the Cuban government has always acted quickly and with resolve when it has had to do it.

Bearing this in mind, it is hard to believe that unification is a top priority when after nearly three years of announcing its impending implemenation, the process has been reduced to a few tweaks. Allowing payments in CUCs in the non-subsidized stores is the only move in favor of the CUP since 2013. However, the only effect of this measure is saving the Cuban people having to make long lines at CADECA exchange houses, while the Government hedges further exchange risks, since about 90% of transactions in the non-subsidized retail network are conducted in CUC.

What would happen if the CUC were put to bed? Any realistic scenario should be based on the assumption that neither the military nor foreign investors would embrace the feeble CUP. It is worth remembering that investors are already entitled by the foreign investment legislation to get revenues in hard currency. The question that arises is who is going to bear the exchange risks? The Cuban state?

Under a non-CUC scenario, Cuba has two options. One, conducting all transactions in CUPs, which means getting into the unknown forest of exchange risks. Two, coming back to the 1980s and forcing a segmentation of retail markets, already overcome, with some retail facilities operating in hard currencies and other accepting CUPs. Needless to say, low quality and inferior goods will end in the CUP network, while the upper tier of hotels, restaurants and stores operating in hard currencies will sell the better products. This is exactly what happened during the 1980s, a time that the Cuban people do not want to relive, in spite of what some pundits still believe.

Furthermore, this second option is not rational from any point of view. During the 1980s and early 1990s, only a very small number of Cubans had access to hard currencies. Under these circumstances, locking out most Cubans off the dollarized network was not a problem for the Government in economic terms. Now, with more and more Cubans holding U.S. dollars, CUCs and other hard currencies, the government cannot exclude them from top retail stores without inflicting itself significant economic damage.

There is a third option in case the CUP takes over: a Venezuela-like scenario, where a small group of privileged firms and entrepreneurs enjoy a special rate to buy the hard currencies they need. The macroeconomic mayhem that this scenario would trigger is a powerful reason for the Cuban government to rule it out.

Getting the Right Price

Most of the debate and opinions on the unification issue hinges on determining the right exchange rate, the real parity that could allow the unification via the CUP.

Experts have come up with a variety of ideas and proposals. They implicitly assume that getting one price right is all that is needed. However, the issue is not getting one price right at one time, since the exchange rate is a variable price, subject with the ups and downs of any market.

No one but the market can set the right CUP/U.S. dollar exchange rate in a single currency scenario. Once again, the unanswered question is who is going the take the losses for the fluctuations between the parity CUP/U.S. dollar rate, discarding a scenario of a fixed parity defended by the Cuban Government, an unrealistic scenario.

THE UPHILL ROAD FOR MONETARY UNIFICATION

The need for a monetary unification has been a key component of the official rhetoric in Cuba for the past fifteen years. Since the aftermath of the authorization to hold and use U.S. dollars in 1993, the Cuban government has portrayed monetary dualism as a temporary, painful but necessary measure.

In spite of the official rhetoric, and in spite of the takeover of the CUC in 2004 and the trumpeted promise in 2013 to end monetary dualism, Cuba has made little progress in that direction, and the U.S. dollar remains as the favorite currency of the Cuban leadership.

The odds of a monetary unification will improve as long as it proves to be more convenient and useful for the Cuban leadership. So far, this is not the case.

Unlike most countries in Latin America, where the episodes of currency substitution were basically a rational response of individuals to devaluations and financial crises[11], dollarization in Cuba has received strong Government sponsorship. Furthermore, the government's ownership over a big share of the dollarized economy and its absolute control over the external sector encourage the Cuban government to stick with the U.S. dollar. In a nutshell, pricing in U.S. dollars is a privilege for economic and political elites in Latin America.

As we have explained in this paper, the Cuban leadership is not truly urged to uproot the U.S. dollar from the economy. They would have to lift many barriers and restrictions before the dual system becomes an effective obstacle.

The increasing economy power of the military establishment, embodied in holding companies GAESA (Grupo de Administración Empresarial) and CIMEX is a very particular feature of the Cuban society. The military economic complex will likely survive any scenario of political transition in Cuba. This economic giant is already sowing the seeds of owning the largest private firms in Cuba over the next ten to fifteen years.

The Army keeps taking over more areas of the Cuban economy. There are no official statistics about this parallel structure, which in the books belongs to the Cuban state, but in fact resembles big Latin American conglomerates.

11. Pérez, Lorenzo (1994), "The Implications of Currency Substitution Experiences in Latin America and in Eastern Europe for Cuba", *Cuba in Transition—Volume 14.*

It is not a coincidence that new consumption options open to the population since 2013 (internet, mobile phone, car sales) are priced in CUCs and are offered for sale by companies controlled by the military holding. It is hard to imagine GAESA or CIMEX taking the economic risks inherent to a monetary system governed by the CUP, in an economy free of the multi exchange system and without the cushion that the CUC provides. The Army and foreign investors share the same affection for revenues in hard currency, and their lack of confidence on the CUP. The CUP is still too weak to take a lead role and work alone in the Cuban monetary system.

In addition, the news from abroad are not good. The external sector of the Cuban economy remains vulnerable. Two of its largest economic partners, Venezuela and Brazil, are in dismal economic situations. Economists disagree on the magnitude of the shock that Cuba would face if the special partnership with Venezuela ends. But it is clear that for Cuba, even in the best case scenario, the economic struggles of Venezuela and Brazil will have significant adverse impacts. The turnaround in U.S. policy towards Cuba has unambiguously fostered tourism, but Cuba has yet a long road to walk before receiving significant capital inflows from the U.S.

In such a cloudy environment, it is highly probable that the U.S. dollar stays as the reference currency for the Cuban government. The U.S. currency will likely play a key role in any further integration with foreign investors and the rest of the world.

Dollarization in Cuba has shown an unusual resilience. This persistence is deeply rooted in the fundamentals of the Cuban economy. The Government and the Cuban people have converged in favoring foreign currencies over the CUP, the national currency. At present, the odds for a monetary unification through the CUP are at their lowest ebb ever.