CUBA'S CURRENCY DILEMMA: TO CONVERGE—HOW AND WHEN

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Cuba has two official currencies: the Convertible Peso (CUC) is linked to foreign trade and is used by a relatively small segment of the population; the Cuban Peso (CUP) is used by the rest.[2] There is a significant gap between the external value of these two currencies, with the CUC trading about at par with the U.S. dollar and the CUP at about 24 to the dollar. This system, in place now for more than two decades, not only creates severe monetary distortions with adverse effects on economic performance but also, and importantly, the widely diverging exchange rates between the two currencies are creating a political problem for the Cuban regime.

The Cuban economy is becoming increasingly bifurcated, with a sector basically operating on the CUC standard and enjoying rising incomes, while most of the population earns meager salaries paid in CUPs, used mainly in the rationed market, and cannot afford many goods and services available only in CUCs at prices that are out of their reach. Those with access to foreign exchange have privileges that those who deal in the CUP economy do not have, nor can aspire to have under present conditions. The result is a visible and rising inequality of incomes, and this development grates against the core of the government's revolutionary principles. And therein lies the regime's *dilemma.*

This paper takes the view that, notwithstanding official pronouncements and foreshadowing by independent observers that exchange rate unification is around the corner, there is considerable evidence that the authorities are finding the *how* path to convergence politically and technically difficult. In fact, the gradual approach being pursued is creating confusion and further economic distortions and, therefore, it is argued here that expectations as to *when* a rapid convergence is to be achieved are receding.

There is little doubt that the authorities are keenly aware that ending the misallocation of resources arising from the current monetary system is essential if Cuba's economy is to operate more efficiently and become more productive. They readily acknowledge the importance of improving economic performance and that currency duality is one of the obstacles that stand in the way in achieving that objective. One of the most important goals of the 2011 "Guidelines for Economic and Social Policies"[3] in the monetary and financial spheres called for ending monetary duality by 2016 at the latest.

THE ROAD TO CONVERGENCE (LESS TRAVELED)

To this end, the Government first announced in late 2013 that certain measures were to be set in motion

1. My thanks to Roberto Orro for his useful comments and suggestions.

2. The U.S. dollar is also used extra-officially for transactions between private businesses, visas, gratuities, and by shopkeepers.

3. *Lineamientos de la Política Económica y Social del Partido y la Revolución*, approved on April 28, 2011 during the 6th Congress of the Communist Party of Cuba.

with the goal of moving to one currency. In 2014, state companies were told to begin preparing for the coming unification, dubbed "Día Cero" (Day Zero), and in preparation the government started listing prices in both CUPs and CUCs. There continues to be a persistent drum beat that exchange rate unification is in the offing.

The government is acting as though it is laying the ground work for action on exchange rate unification. Raúl Castro himself with impeccable logic declared during a session of the National Assembly in December 2017 that "monetary duality is a problem that needs to be dealt with forthwith." This tended to cause anxiety as to the implication for savings, which led to some currency speculation. To calm rumors that convergence was in the works and to discourage a bank run, government officials have repeatedly stated that the process of monetary unification will be carried out in a manner that will respect and protect the value of bank deposits in CUCs and CUPs. In other countries when such statements were made, they signaled that devaluation was imminent and had an effect opposite to that intended. In Cuba, however, the veiled warning against speculation had the desired effect.

CURRENCY DUALITY OR EXCHANGE RATE UNIFICATIONS

It should be noted that eliminating duality can be achieved without necessarily unifying the exchange rates. At various times, particularly in decades past, many countries have faced the complicated job of eliminating multiple exchange rates, whether these were officially sanctioned, illegal, or illegal but condoned. Ending currency duality in Cuba should be an easier task than achieving exchange rate unification. After all, government salaries can be paid in CUPs at the present monthly rate of about 720 CUP, or at its equivalent of 30 CUCs since the CUCs are no longer backed by foreign exchange reserves and can be created by fiat. Just the same, a state-owned enterprise can pay 24 CUPs or 1 CUC for an imported input that costs one U.S. dollar. The distortion lies in the implicit subsidy when access to a preferential exchange rate allows the firm to pay not 24 CUPs for a dollar but just one. The existence of parallel exchange markets gives rise to what the IMF calls "Multiple Currency Practices,"[4] not because the country has two currencies but because it has exchange rate arrangements that deviate from unrestricted convertibility at uniform fixed or flexible exchange rates.[5]

It might be possible to eliminate one of the two currencies, probably the CUC, without necessarily unifying the exchange rate. If duality is eliminated, but the exchange rates remain apart, as noted earlier the public enterprises lose a previously implicit subsidy which now becomes explicit. Absent measures to allow the company to operate more efficiently, the central bank will be issuing more CUPs to cover the company's shortfall. In terms of the money supply, after the subsidy is made explicit and financed by the central bank, there will be more CUPs in circulation and fewer CUCs. The central bank could then sterilize any excess supply of CUPs selling CUCs at 24 to 1. But if the intention is to get rid of one of the two currencies, U.S. dollars could be used to mop up CUP liquidity which would require restoring the public's ability to legally hold foreign exchange.

The authorities, however, cannot count on the public's willingness to hold excess money balances for long, and may not have sufficient international reserves for sustained intervention in the exchange market, unless they are willing to float the currency. In sophisticated economies the lag before an excess money supply spills over to prices or the balance of

4. Article VIII of the International Monetary Fund (IMF) Articles of Agreement.

5. An IMF member seeking financial assistance would be required to unify the exchange rate system if the spread between the two rates exceeds 2 percent. This can be accomplished in a variety of ways. It can be done in one step with macroeconomic policies in place to prevent a burst of inflation, or it can be done by transferring transactions on a pre-determined schedule to the more depreciated rate in the parallel exchange market from the usually overvalued official rate. During this transition individuals and firms with the best political connections (the military, for instance) are the last to lose access to the preferential exchange rate, often with some temporary inducement, although this is not an approach that the IMF would advocate.

payments would be short. But, in Cuba's rudimentary economy, with price controls in place and shortages of foreign exchange, getting rid of duality might buy the government some time for policy adjustments to go into effect before large CUC spreads versus the dollar re-appear. There is anecdotal evidence that the U.S. dollar is selling at only a small premium in the streets despite a growing deterioration in the public finances over the last three years financed with central bank credit (further details on fiscal and monetary trends below).

In any case, the self-imposed 2016 deadline to do away with duality has passed. Except for isolated experiments with a more devalued CUP for transactions between state-owned hotels and restaurants and agricultural cooperatives and between certain state enterprises,[6] there has been no strong push to proceed with the long-promised convergence of the two currencies.

REQUIREMENTS FOR EXCHANGE RATE UNIFICATION

In deference to the authorities, there are good reasons for these delays for much needs to be considered before launching a transformative currency reform, especially in a command and control economy. A wise man once said that plans are useless, but planning is essential.[7] The policy mix to accompany currency convergence, or for that matter any major exchange rate action, must be carefully thought out. The process of eliminating the large spreads between the exchange rates for CUPs and CUCs, whether rapidly or gradually, needs to be accompanied by policies to keep inflation in check as the overvalued currency is re-priced. Macroeconomic policies need to be fine-tuned, no easy task, to keep expansion of aggregate demand from undoing the effects of the devaluation. Once reform measures are set in motion the authorities must be ready to adapt policies and act promptly as the economy reacts to the change in its key price. Above all, the fiscal and monetary stance must be kept under tight control and wage pressures contained. The effects of the peso devaluation will quickly dissipate if the central bank is pressed to print money for subsidies to state-owned enterprises or other sectors, whether through the public finances or directly as quasi-fiscal credits, to compensate for the higher cost of inputs that previously benefited from access to the preferential exchange rate,

Decisions need to be made on whether the currency is to float freely to find a new level or to fall gradually or in one discrete step. For the latter options to take place in an orderly fashion, the monetary authorities will require an adequate level of foreign exchange reserves and expertise in managing exchange intervention. Central Bank reserves need not be as large if the decision is to float the currency. Whether "shock therapy" is applied or a managed float is pursued, a responsible government would need to address some of the costs of the CUP devaluation, including protection for the poorest groups of the population, but without undermining with budget-busting subsidies the objective the exchange rate action was to have achieved: a more realistic external value of the currency and a re-allocation of domestic resources toward productive uses as relative prices of tradables and nontradables change.[8]

A currency can become overvalued for a number of reasons, including often when home wages outpace productivity gains and labor costs run higher than those in competing trading partners. In these circumstances, exchange rate depreciation can be expected to lead to a fall in real wages, if the fall of the currency is not negated by inflation. The price relationship between domestic tradables and nontradables is crucially affected as the external value of the currency is re-valued and resources are re-positioned domestically.

6. At CUP7 per USD1 as of December 2011, raised to CUP10 per USD1 in 2013.

7. Dwight D. Eisenhower.

8. Examples of tradable sectors: agriculture, mining, manufacturing, tourism-related. Nontradables: electricity, construction, wholesale and retail, transport, government services.

In general, the prices of nontraded goods fall relative to the price of traded goods and, at the same time, production of nontraded goods declines while production of traded goods rises. This shift of resources into tradables (in Cuba's case today, tourist-related activities) will follow a devaluation provided, as noted, that concurrent macroeconomic policies (fiscal, monetary, wage policies) ensure a decrease in the demand-supply balance for nontradables. As production shifts out of nontradables (say, out of government and state enterprise work) into presumably performance-improving private ventures, there is likely to be a period of temporary unemployment while displaced workers take time to match up new job opportunities or seek funding to start businesses, provided these movements are allowed to occur. During this period there will be winners and losers, and costs and benefits. The costs, however, are immediate while the benefits become apparent over time as economic agents take advantage of new profitable endeavors. All this creates excruciating political anxiety, and it takes political courage to see it through.

This transition can take place quickly if the government chooses to let market forces operate by freeing the exchange rate until it finds a new real equilibrium, which in Cuba's case would mean a significant correction of the CUP towards convergence with the CUC at a rate which may not necessarily settle at the current 24 to 1. Or it can be stretched over time through a managed float or discrete steps towards a new external value. Experience shows that the latter approach can lead to a backlash as reform fatigue sets in interrupting progress towards unification. Even if popular angst is contained, a slow transit to currency unification will give rise to opportunities for speculation, corruption, and rent-seeking activities which would further muddle the path to reform. Either way, the process of exchange rate unification is fraught with political risks, even in a command and control economy, which explains the authorities' apparent hesitancy to carry on.

ROADBLOCKS

Another major unknown is the extent to which the government is willing to allow the process of the reallocation of resources from government work to the private sector to unfold without worsening further the already skewed distribution of income, which is a major source of regime irritation. In this context, it is instructive to recall the third *Lineamiento* approved during the 2011 6th Congress of the Communist Party: "In the new forms of non-state management, the concentration of ownership in legal or natural entities shall not be permitted." Consistent with this statement, Raúl Castro recently remarked that "small business owners, particularly those involved in tourism, are enjoying incomes well above the average, and this fact is becoming a source of concern to the government." He is right. A one-night stay by a tourist in a room in a *casa particular*,[9] or a taxi ride from José Martí Airport to downtown Havana (US$30) will earn the home owner or the taxi driver as much as a month's salary of a government worker.

The government could turn to foreign investment to ease balance of payments pressures and facilitate the process of exchange rate unification and, at a later stage, peso convertibility. However, there are no indications that the official position prohibiting foreign investment is being relaxed, except for projects in partnership with the government and with severe limitations on profit repatriation.

Similarly, there is no evidence that further liberalization of the private sector is in the cards beyond the timid steps taken allowing *cuentapropistas, casas particulares, and paladares*[10] to operate. On the contrary, that small opening to private activity, which in recent years allowed some 12 percent of the labor force to work outside government, is about to be closed. Recently, Vice-President Marino Murillo declared that "the government will not allow the concentration of wealth and property, although it will permit limited forms of private activity."[11] To reinforce this policy, in late 2017 the government stopped issuing business

9. Bed and Breakfasts.

10. Shopkeepers and other micro enterprises, rooms in family homes (BnBs), and small family restaurants.

licences altogether for several months. Licenses began to be issued again in July 2018.

Additionally, on July 13, 2018 the government issued extensive and highly detailed regulations[12] to go into effect on December 7, 2018 (running 129 pages in the Official Gazette) that will make it extremely cumbersome to operate private businesses, effectively eliminating the possibility for franchising and diversification. The new rules reduce the number of categories of self-employment to 123 from 201 and limit the issuance of business licenses to one activity per individual, and one license for only one type of business. In other words, the possibility to operate a *paladar* and a *casa particular*, or several *paladares* or *casas particulares* would be eliminated, although in principle these restrictions perhaps could be bypassed by transferring licences to family members. The proposal also limits the number of seats in restaurants to 50, while the more successful establishments currently seat 100 or more. In some cases the smaller number of categories reflects consolidation of several related activities, which can be considered a positive step. At the same time, the new regulations are clearly designed to expand government control over private sector activities with performance requirements so specific as to make compliance difficult and giving inspectors wide discretion to interpret intrusive rules. The number of *cuentapropistas* had surged in recent years to close to 600,000 in 2018, from a little over 150,000 in 2010[13]. The latest rules cannot help but to put a brake on further rapid growth. Their intent is to diminish the risk of commercial and political competition from an increasingly wealthier private sector.

A further obstacle thrown in the way of private activity is the threat that imported products could be confiscated if they are brought in by individuals not licensed by the government and processed through government channels. This action would disrupt the supply of imported goods for small enterprises through *mulas*[14] and would harm the operation of business as access to government-controlled wholesale markets is limited and inventories are scarce or unavailable. Changes are also being felt in agriculture where a more progressive income taxation is being planned that will affect the most efficient farmers.

These measures are clearly intended to limit the growth of the private sector and keep it from competing with government interests. They also would make it difficult for the private sector to absorb redundant labor as part of a reform of the state enterprise.

MANAGING THE TRANSITION

The thorniest question facing the Cuban authorities as they ponder the need to end multiple exchange rates is how they are going to manage politically a devaluation of the peso without a concomitant drop in real wages, rising unemployment, and major disruptions in the supply chains of state-owned enterprises as they face rising costs. Is the Government going to allow the purchasing power of the monthly earnings of most of the population, which means those in state employment, to drop below the current equivalent of about US$30 monthly? When a bus ticket costs now one CUP (less than a U.S. nickel), how are the transportation companies going to cope with the rise in fuel costs following convergence to a re-valued peso—by raising fares? Or, are subsidies to transportation and a myriad of other affected sectors the answer, thus undoing through deficit financing and inflation the effects of the CUP devaluation. These issues must weigh heavily in the mind of the authorities and seem to be driving their policy actions, and inactions.

The conditions for exchange rate unification were ripe a few years ago when Raúl Castro first said that "the economy needed to operate more productively for growth to accelerate and that the peso had to be realistically valued for this to occur." At that time,

11. On May 31, 2018, at the Asamblea Nacional del Poder Popular.
12. *Gaceta Oficial*, July 10, 2018, No 35.
13. From 157,354 in 2010 to 591,456 in 2018, to be exact.
14. Private couriers.

not long ago, Venezuelan aid was in full force and tourist receipts and remittances boomed when the U.S. re-established formal diplomatic relations with Cuba and travel to Cuba by Cuban-Americans was relaxed. At present, however, the economic situation has taken a turn for the worse. The fiscal deficit is rising, it is being financed by printing both CUPs and CUCs (the latter no longer operating as a currency board), there is no capacity to borrow, tourism and remittances are flattening, economic performance is spotty, and international reserves are scarce. In sum, the authorities are likely to see the current economic setting as hostile to a major policy change; moreover, they are adopting policies that, while consistent with their ideology, tend to work at cross-purposes for creating conditions for the orderly convergence of the two exchange rates. There is a glaring contradiction in that, on the one hand, the regime understands clearly that currency reform is essential to improve economic performance and have repeatedly said so, but on the other hand, side measures are introduced that pull in the opposite direction. The two goals are incompatible.

THE MACROECONOMIC BACKGROUND

It has been noted that appropriate fiscal and monetary policies must pave the way for a smooth transition to one currency and one exchange rate. Let's review where these policies stand.

On the fiscal front, in a recent blog Ernesto Hernández-Catá notes[15] that in the three-year period to 2016, the fiscal stance has turned increasingly expansionary. Revenues have stagnated, and government spending accelerated, particularly in 2015–16 compared to marginal changes in the previous three years. Partly contributing to higher deficits was increases in wages, which averaged 15 percent a year in the three years to 2016, a significant change from the smaller increases observed in earlier years. Because of these trends, the overall fiscal deficit rose to 5.1 billion pesos in 2015 (5.2 percent of GDP) and 6.1 billion in 2016 (6.0 percent of GDP), up from a little more than 1 billion pesos (1.3 percent of GDP) on average in the previous three years.[16] The impact of hurricane Irma also created big gaps in the budget, with the deficit widening to 11.7 billion pesos in 2017 (11.4 percent of GDP)[17].

Monetary developments in CUPs and CUCs have followed different paths over the last few years. Data for monetary aggregates in CUPs are available while for CUCs, although not published, movements can be inferred in various ways. Here we draw from Luis R. Luis[18] estimates of the monetary base in CUCs and assuming for CUCs the CUP money multiplier[19]. This calculation shows that, in sharp contrast, the circulation of CUCs expanded by 30 percent during the three-year period 2011–2013, far more rapidly than the 4.7 percent increase in the CUP money supply. The same divergence occurs in reverse in the 2014–2016 period with the CUC expansion slowing down to 13 percent over this period, while the growth of the CUP money supply accelerated to 16.6 percent over the same period. These developments are consistent with trends in the external sector in the wake of the re-establishment of diplomatic relations with the United States and a surge in tourism (reflected in CUC emissions), followed more recently by fewer arrivals, lower oil deliveries from Venezuela, and more expansionary fiscal policies (financed with CUPs) to sustain economic activity.

15. Ernesto Hernández-Catá, "Cuba's Macroeconomic Policy's Aggressive Shift towards Expansion," ASCE Cuba Blog, www.ascecuba.org, February 13, 2018.

16. The effect of the fiscal deficit on the monetary aggregates and the balance of payments may differ depending on whether the deficit originates in the CUP account or the CUC account, as DiBella and Romeu noted in "Operational Issues of Currency Unification in Cuba: A Note," *Cuba in Transition—Volume 27* (2017).

17. According to Minister of the Economy Ricardo Cabrisas Ruiz, "A Realistic Perspective on the Economy," *Granma*, January 11, 2018.

18. Luis R. Luis, "Unifying the Cuban Paso: Tentative Numbers," ASCE Cuba Blog, www.ascecuba.org, January 27, 2018.

19. My assumption.

Earlier it was noted that CUCs are no longer backed with foreign exchange reserves. For a time when the CUC was first introduced in 1994, the central bank basically ran a currency board with full foreign exchange coverage of CUCs. As the years wore on and balance of payments imbalances pressed on the official international reserve position, the foreign exchange backing of the CUC was progressively reduced. By end-2016, Cuban assets at BIS banks (a proxy for international reserves) stood at US$2 billion (having fallen gradually from US$5.5 billion in 2010), providing a coverage of less than a quarter of estimated money supply in CUCs.[20] This means that for all practical purposes there is no foreign exchange backing for the CUC liabilities of the Central Bank, as the monetary authorities would not be inclined to totally deplete the official international reserves for the sake of eliminating the CUC from the economy. To put it differently, the CUC has become the equivalent of a quasi-export surrender requirement intended to keep foreign exchange out of the hands of the public, and no different than the CUP as both are now created by fiat. Unless the government-dominated central bank applies a tighter grip on money creation, the taxing powers of the CUC would be one of the first casualties as the public becomes more emboldened in illegally using and hoarding U.S dollars and other foreign currencies.

CONVERGENCE AT WHAT RATE?

Reportedly, expectations among the public abound that currency reform might result in an increase in the purchasing power of the CUP. In fact, such an outcome is unlikely, but it could be engineered if the value of the Cuban peso would rise in relation to the convertible peso. Hints that such an outcome is in the works could provoke a retreat from the public's willingness to hold CUCs, as it would amount to confiscation of savings. It could lead to a rapid destabilization of the exchange market, especially if such a move is telegraphed by a decision to approach currency unification gradually.

So far, it appears that the deterioration in financial conditions and statements about the government's concerns about wealth-creating activities and related proposals to slow private sector liberalization has not had a sizeable influence on the street value of the CUC. The U.S. dollar is trading at a premium about equal to CADECA's[21] tax on dollar conversions to CUCs, though the premium is said to be running a little higher for some transactions, which suggests that the stability of the CUC is fragile and could become untenable if inflation re-appears and CUC holders grow concerned about the value of their holdings and the possible demise of CUCs.

CONCLUSION

It is possible that the authorities will consider these observations to be flat off base, and it is hoped they are ready to act and prove wrong the views expressed in this paper. However, I cannot help but think that the authorities view the evolution of the economy and its prospects with some trepidation and thus hesitate to act on the exchange rate. They know that rising income inequality is inimical to their professed political ideology, although I would hope that in quiet moments they might allow themselves to think that some disparity in income is unavoidable as space opens for market forces to operate somewhat more freely.

In recent years, the shift to the private sector of many thousands of former government workers has put a dent on unproductive labor. This should be seen as progress and not a threat to the authorities' political control. But the job is far from done as many more valuable citizens toil in loss-making enterprises or government jobs producing little economic and social value. They deserve a chance to apply their energies and considerable Cuban ingenuity to more rewarding endeavors even if some realize gains larger than others, which could be addressed through a moderately progressive tax system. Greater opportunities for *cuentapropistas* and private micro enterprises would make room for inefficient state enterprises to cease to operate or release redundant labor without creating unemployment or lowering real wages. Such an approach greatly would ease the path to currency reform.

20. These numbers, as with all Cuban statistics, must be interpreted with caution as data on the circulation of CUCs are not available and estimates on the CUC monetary base and money supply are derived.

21. Government-operated money exchange houses.