

Is Cuba's Economy Ready for the 2018 Leadership Transition?

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Cuba has changed considerably in these last ten years of economic reforms, though not enough. Family income, tourist services, food production, restaurants, and transportation depend less on the state and much more on private initiative. The real estate market, sales of diverse consumer goods and services, and the supply of inputs for the private sector have all expanded, in formal and informal markets. Foreign investment stands out as a fundamental factor in Cuba's development. The country has achieved important advances in the renegotiation of its external debts.

Nevertheless, many other announced changes were defeated by internal resistance, half-heartedly implemented, or put in place in ways that replicated mistakes of the past. The bureaucratic and inefficient state enterprise sector, tied down by low salaries and a strict central plan, impedes economic progress. Cuba's advantages in education and human capital continue to be underexploited. Neither has the international environment provided much help. The U.S. trade embargo remains in place, the Trump administration has returned to the old and failed rhetoric of past U.S. policies, and Cuba continues to depend on a Venezuelan economy that does not yet seem to have hit rock bottom.

As a consequence, the growth of GDP and productivity has been disappointing, agricultural reform has produced few positive results, and Cuba is once again drowning in a financial crisis. The reforms implemented to date did not create sufficient quality jobs, and, all told, half a million formal positions were eliminated from the labor market.

The second half of 2017 proved especially challenging due to the impacts of Hurricane Irma and new restrictive measures announced by the U.S. government. To these difficulties one must add the decision of the Cuban government to freeze (temporarily) the issuance of licenses to the private sector.

Even so, the National Office of Statistics and Information (ONEI) reported that the economy has not fallen into recession. There are reasons to doubt these statistics, however. Such doubts only multiply when we take into consideration the decision to delay, or altogether avoid, the publication of reports on individual sectors of the economy and the state of the national accounts.

For 2018, the government has proposed a rather optimistic economic growth plan (2% increase in GDP) that once again does not appear to

appropriately evaluate the complexity of Cuba's macro-financial environment. Three highly significant events are anticipated this year: the generational transition within the government, new norms for the private sector, and the beginning of the currency reform process. These three issues have raised expectations on the island, but each may be tackled in a disappointing fashion.

CHANGES IN PRODUCTION AND EMPLOYMENT

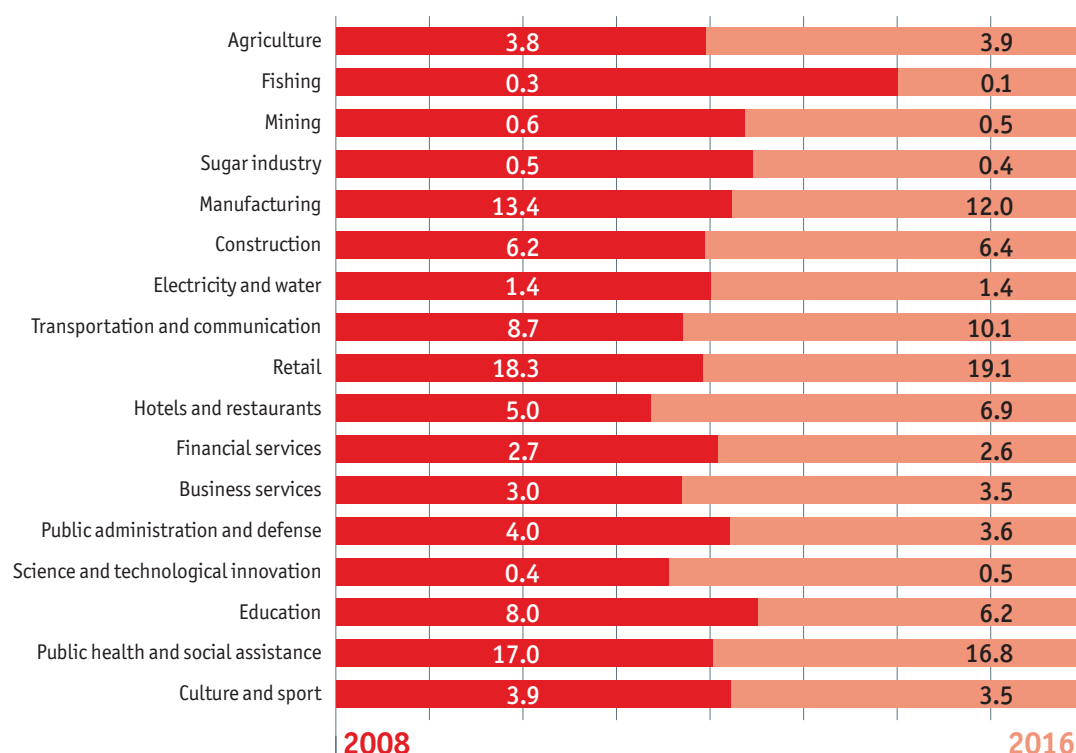
According to the official ONEI statistics, Cuba's GDP growth averaged 2.4% per year between 2008 and 2017. This is much lower than the goal of 4.4% that the Cuban government proposed for the same period. A low rate of physical capital accumulation, emigration and population decline, and the deceleration of productivity all played a part in bringing about this unsatisfactory result.

Neither agriculture nor industry responded to changes in regulations as was hoped. Instead, Cuba achieved modest GDP growth due to the services sector. In spite of the importance assigned to the production of goods in the government's strategy for "updating" Cuba's economic model, the weight of said sector as a percentage of GDP fell from 25% in 2008 to 23% in 2016. By contrast, 77% of Cuba's economy depends on services, notwithstanding the fact that food production is insufficient to meet the needs of the population and industrial production remains underdeveloped. This structure reflects the imbalances of Cuba's inherited economic model, which the government's reforms, thus far, have been unable to substantially change.

Indeed, all sectors in which goods are produced experienced a decline in their percentage of GDP between 2008 and 2016, with the exception of construction and agriculture, which grew marginally (See Figure 1 with the updated statistics from the most recently published ONEI yearbook). The goods-producing sector that suffered the strongest contraction was manufacturing, losing 1.4% within the total GDP profile (from 13.4% to 12%). Agriculture, which was one of the sectors prioritized for the most transformation since the beginning of the reforms, only increased its contribution as a percentage of total GDP by 0.1%.

The rise in the weight of services does not reflect an increase in the provision of education or health and social services; these, in fact, contracted 1.8% and 0.2% respectively within the GDP total. Public administration and defense also decreased in importance by 0.4% (from 4% to 3.6%).

FIGURE 1. Composition of GDP in main sectors



Source: Created by author based on data from the Statistical Yearbook of the ONEI.

Instead, the increase in services can be explained principally by growth in the value of hotels and restaurants (1.9%), transportation and communications (1.4%), and of retail sales (0.8%). Behind these increases, one can identify factors such as the expansion of cellular service, the elimination of restrictions on domestic tourism, the increase of private businesses related to lodging and gastronomy, an increase in foreign visitors, and investments in tourism.

In parallel with these changes in the productive structure, Cuba has experienced a significant redistribution of its sources of employment. In the state sector, one million positions were eliminated; the state went from generating 84% of total employment in 2009 to being responsible for 71% in 2016. For its part, the private and cooperative sectors created a bit more than half a million positions, and are currently responsible for 29% of employment (17% in cooperatives and as farmers, and 12% as “self-employed workers” or in private enterprises). The majority of these new jobs are concentrated in low-value-added activities.

TABLE 1. Redistribution of Employment

(by thousands of workers)

	2009	2016	Variation
Total Employed	5072.4	4591.1	-481.3
State and mixed-enterprise sector	4249,5	3250,7	-998,8
Non-state sector	822,9	1340,4	517,5
Self-employed workers and private enterprises	143,8	540,8	397,0
Cooperatives and farmers	679,1	799,6	120,5

The ONEI statistics thus reveal that the economy as a whole eliminated almost half a million formal jobs between 2009 and 2016. Considering that the unemployment rate continues to be extremely low (2% in 2016), one can conclude that these half a million Cubans are not actively searching for work. That is, this is a segment of the population that either retired or continues to be of working age but is not looking for formal employment in the country. The emigration of youth abroad and informal activities linked to the formal private sector help explain where some of these half a million Cubans ended up.¹

CUBA'S FINANCIAL CRISIS AND IMPORT ADJUSTMENT

The continuing impact of the Venezuelan crisis and the resulting decline of export income have made it impossible for Cuba pay all of its pending debts, even though this was the expressed intention of the government. Cuba's banks and its currency cannot count on the minimum backing of foreign currency liquidity that would allow a restoration of the economy's financial stability. Faced with the absence of sufficient foreign earnings in hard currency, the government maintains a selective, discretionary policy for paying debts and imports.

The data reported by ONEI for 2016 show that Cuba's export of goods fell 29%. The economy took in one billion dollars less in comparison to 2015—due solely to the decrease in exported goods. This confirms the gravity of the adjustment in Cuba's foreign trade accounts.

As a result, imports decreased in 2016 by 11%, an equivalent of \$1.47 billion. This adjustment was concentrated almost completely in the decrease in the importation of intermediate goods (including oil from

¹ The data on emigration that is reported in official statistics does not coincide with labor market statistics due to the fact that ONEI has long significantly underestimated the rate of emigration. This is because it considers any Cuban who travels to the country at least once every two years as a "resident".

Venezuela). The importation of consumer goods decreased only by \$81 million, while the importation of capital goods increased \$21 million.

These statistics allow us to glimpse the preferences the government is applying in order to manage the financial crisis. Officials have prioritized investment at the same time that they have accelerated the approval of projects with foreign capital. In this way, imported capital goods are in large part auto-financed by the arrival of foreign capital within the approved project. Another priority is to affect family and tourist consumption as little as possible.

For 2017, the partial data currently available shows that, even when authorities have been able to find commercial alternatives to the economic collapse of Venezuela—whether through the importation of oil from other markets or by mobilizing resources and merchandise through new foreign investment projects—the adjustment in importations had to continue. In the span of the past year, we can estimate that imports declined by approximately 10% (calculated using a sample of Cuba’s commercial exchange with its 10 largest trading partners).² The largest decrease in importations came from China, with a decline of roughly 30%.

TWO SHOCKS AT ONCE: IRMA AND TRUMP

Two new negative external shocks added to this complicated macro-financial situation in the second half of 2017: Hurricane Irma and worsening relations with the U.S. government.

After the hurricane, the Cuban government demonstrated its capabilities by reorganizing public services in a relatively short time. This contrasts notably with the situation experienced in Puerto Rico. The tourism sector was able to recover in record time from damage to hotels and infrastructure. Meanwhile, using the state budget, the government established a subsidy to finance 50% of the cost of construction materials and basic necessities for affected families.

Nevertheless, this does not mean that all of the storm’s damage has been repaired, or that the costs of the climatic event will all be compensated. Low levels of investment and a limited capacity to provide financing have not allowed the government to recover all damages to industry, agriculture, livestock, and housing. In spite of efforts to prioritize tourism for recovery, figures show that the

² See *Cuba Standard Economic Trend Report* (www.cubastandard.com)

pace of arrival of visitors did significantly slow in the last months of the year. The most recent information about the state of the sugar harvest likewise testifies to the cost that the hurricane will have on the production of sugar in 2018.³

The second negative shock of the last half of 2017 came as a consequence of the Trump administration's restrictions on the travel of U.S. citizens and U.S. trade and investment with Cuban companies controlled by the island's armed forces. It is worth recalling that the increase in foreign direct investment and the growth of the tourism sector in recent years were largely driven by the reestablishment of relations with the United States in 2015. For foreign companies, this development reduced the risk of trade and investment relationships with the island. Normalized relations also strengthened the expectation that ties with Cuba would be rewarded with higher returns, given the possibility that the U.S. embargo would be lifted. At the same time, the flow of tourists from the United States and the rest of the world grew, which made tourism into the most dynamic sector of the economy. Foreign investment and Cuba's own private sector increasingly became linked to this sector.

As a result, recent setbacks in the relationship with the United States unfavorably affect the objective of increasing foreign investment. Nor are they good news for the development of Cuba's private sector.

For the moment, the Cuban government is trying to show that interest in investing in Cuba remains strong, and authorities have sped up the approval of foreign investment projects that were already under negotiation. In 2017, Cuba approved investments of foreign capital totaling \$2 billion. This is positive news, although it arrives a considerable time after Cuba announced its opening to foreign direct investment. Likewise, it remains to be seen whether this level of investment is sustainable in the coming years, or whether it was a one-time occurrence.⁴

For now, the tourism sector seems to be the most affected by the economic shocks at the end of the year. The number of foreign travelers reached just under 4.7 million in 2017, an increase of approximately 16% over 2016. But this aggregated figure does not allow us to clearly see the deceleration in arrivals after September as a result of trip

3 See <https://www.reuters.com/article/us-cuba-sugar/cuba-cancels-sugar-exports-hurricane-irma-january-rains-hit-harvest-idUSKBN1FI1XA>

4 According to a poll conducted by the *Cuba Standard Economic Trend Report* (www.cubastandard.com) in the fourth quarter of 2017, investors remain interested in the Cuban market.

cancellations and the bad publicity occasioned by the Hurricane Irma and the Trump administration's policies. If the flow of visitors maintained the same pace as it had through August, 2017, Cuba could have welcomed over 5 million travelers. According to estimates in the Cuba Standard Economic Trend Report, due to the shocks at the end of the year, the Cuban market received 300,000 less tourists—almost 18% fewer—in the last four months of the year. Cuba thus lost approximately \$200 million in income.

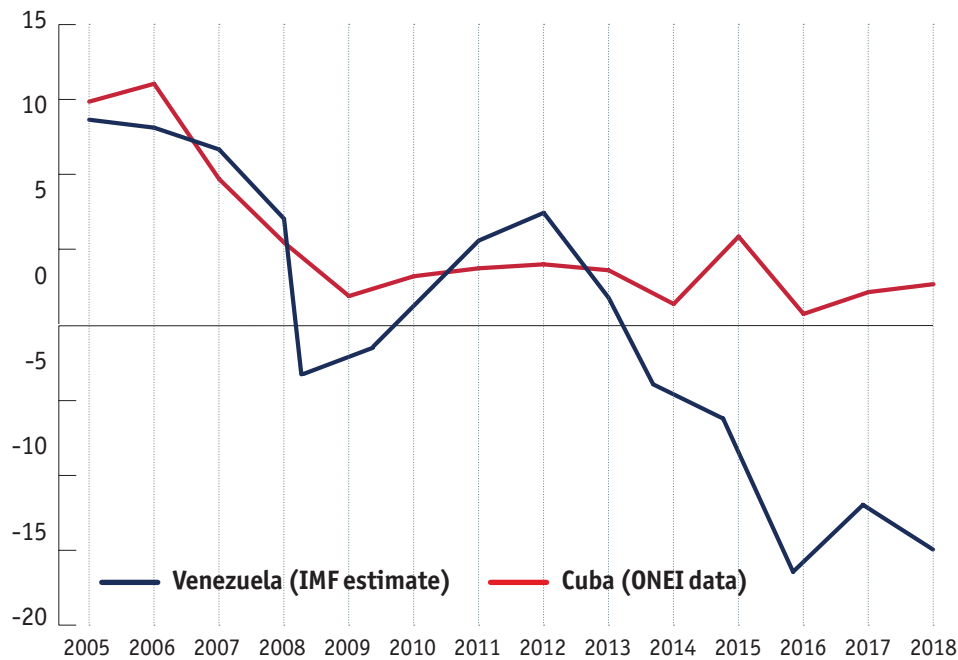
IS THERE REALLY NO RECESSION?

In the sessions of the Cuban National Assembly this past December, the Minister of the Economy surprised observers when he announced that Cuba's GDP grew 1.6% in 2017. Meanwhile, the chapter of the national accounts from the Statistical Yearbook of 2016 has just been republished with a drastic revision of the figures that had been previously offered for that year. It is normal for statistical offices to revise their preliminary data. Nonetheless, in the case of the revisions just made, the panorama of what had been previously presented has now changed substantially. From a reported recession in 2016, we are now told that the economy grew 0.5%. There were also major revisions to the statistics concerning growth in agriculture, construction, and tourism. Agriculture went from zero growth in 2016 to growing 6%. It was said that construction declined 5% and now we are told it grew 4.7%. Meanwhile, the hotel and restaurant sector went from 5% growth to 12%. In other words, the changes are more than noteworthy, and no official information has been given to explain them.

The sectors in which the changes are reported coincide with those where the private sector fills the biggest role. It may be, then, that the revisions are due to a reevaluation of the private sector's weight within GDP. But if this is the case, adjustments should also be made to GDP statistics in earlier years, so as to not distort GDP growth numbers overall.

ONEI's numbers generate two other doubts. First, it does not make sense that the GDP of Cuba's principal economic ally (Venezuela) has contracted 30% in the last four years—affecting Cuba's supply of oil and principal source of export earnings—and that Cuba's economy during the same period has continued to grow (see Figure 2). One gets the impression that the national accounts do not accurately reflect the reality of current commercial flows between both nations. ONEI appears to be underestimating the decline in trade and commercial ties with Venezuela. They are assuming that Venezuela's failure to pay

FIGURE 2. Cuba and Venezuela GDP growth (%)



for Cuban medical services is due to a temporary problem of liquidity. In reality, it is a structural problem, and this permanent issue should be better reflected in the accounting for Cuba's GDP.

Second, there is a disconnect between the positive dynamic of reported economic growth and the negative financial circumstances Cuba currently faces. The problems with outstanding payments and the related financial crisis are much graver than one would expect given the production data published by ONEI. If the data on GDP growth is correct, why are Cuban companies unable to pay their debts? The financial reality does not match the economic narrative that the ONEI presents.

THE ONLY WORTHWHILE CURRENCY REFORM IS STRUCTURAL

One anticipated change in 2018—albeit without knowing the exact date—is the initiation of currency reform.⁵ It is impossible for Cuba to achieve a significant and sustainable improvement in the productivity of its economy so long as it operates with two national currencies, with multiple exchange rates between them and an official

⁵ See <https://www.reuters.com/article/us-cuba-usa/cuba-tells-u-s-delegation-monetary-unification-on-cards-this-year-idUSKCN1G52FU>.

exchange rate that is excessively overvalued. The economy has paid an immense price for this system over time in terms of transaction costs, competitiveness, accounting transparency, and the inefficient assignment of resources.

That said, the government has two options: 1) undertake a structural currency reform with real impacts on the economy, or 2) implement an innocuous currency reform with few real impacts and that leaves intact current prices distortions, depressed salaries, and the financial balances of state enterprises.

In order for currency reform to be effective, and not nominal, benefited sectors should be able to pay higher salaries and use additional profits to (at least partially) make investments, hire more workers, and expand activity. The devaluation of the exchange rate is an opportunity for the government to break the vicious cycle that has prevailed for so long in the state sector, with depressed salaries leading to low productivity, and vice versa. But, to actually break this cycle, Cuba's exporters must not remit all additional profits generated by devaluation to the Treasury (i.e. the State). Instead, exporting enterprises should have the autonomy to employ those profits productively.

At the same time, those enterprises that show permanent losses as a result of currency reform should be merged or closed. A high percentage of the state sector currently operates in a financial bubble sustained by implicit subsidies received every time they pay for imported inputs using an overvalued exchange rate. Many state enterprises' accounts therefore report artificial profits. The financial balances of state enterprises do not reflect economic facts nor the enterprises' true efficiency and productivity. This bubble must be burst, and the state sector must be restructured.

We must bear in mind that the purpose of currency reform is to finally implement an exchange rate adjustment in the state enterprise sector that has been delayed for almost thirty years. This readjustment should have taken place in the 1990s, but it did not occur because economic policymakers sought other means to make do, such as dollarization, multiple exchange rates, the creation of the CUC, and currency controls. While the Cuban population and the private sector adjusted to an exchange rate of 24 CUP to 1 USD in the 1990s, state enterprises continued to operate—through the present day—with the exchange rate of the 1980s: 1 CUP to 1 USD.

Because a 1 CUP to 1 USD exchange rate has long had no relation to the economic reality of the country, Cuba has accumulated large dis-

tortions in its price systems. Likewise, the country has made inefficient decisions guided by absurd financial metrics, all while fostering the survival of enterprises that contribute nothing to the economy. Enormous amounts of financial and human resources have been wasted in supporting state enterprises with no economic value. Had Cuba used these resources more efficiently, Cuban workers would not today earn average salaries of around \$20 per month. It is time that the exchange rate effectively shows which state enterprises deserve capital and human investments.

To soften and manage the impact of a true currency reform, such reform should be accompanied by a greater opening to foreign investment and liberalization of the private sector. Both factors would serve to cushion the financial shock that a devaluation of the official exchange rate will imply. Keep in mind that Cuba does not have sufficient international reserves, nor an international loan, to support its currency reform. For this reason, it is crucial that Cuba open in a way that permits the entrance of sufficient capital to sustain the value of the currency. At the same time, a greater liberalization of the private sector would allow Cuba to absorb the unemployment that would be produced from enterprises that go bankrupt.

As a part of a structural currency reform, considerable sources of employment should move from the state to the private sector. One would hope, therefore, that new pending norms for self-employed workers do not drown the sector while attempting to put it in greater fiscal order. One also hopes that policymakers will take advantage of the moment to finally open the private sector to higher-value-added activities.

On the other hand, the government could once again disappoint, as it did with transformations in agriculture, experiments with cooperatives, and supposed reforms to state enterprises.

The government could try to eliminate the effects of the devaluation completely through subsidies, taxes, and discretionary regulations. In this scenario, non-profitable enterprises would be maintained with state resources, while exporters and other companies benefiting from the currency reform would have to hand over all of their new earnings to the central state budget. Salaries would remain unaffected. Prices would change, but only with the objective of annulling the real impacts of the devaluation and leaving everything more or less the same.

It is logical for the state to attempt to moderate the effects of currency reform through economic policy. It makes sense for officials to permit a

transition period so that the state enterprise sector could adjust to the new exchange rate. But it would be an error to attempt to eliminate all consequences of a devaluation. Were Cuba to do so, the economy could remain at its starting point—with a single currency, but also the same salary distortions and without honestly confronting the economic and financial realities of its state enterprises. If this is the course that Cuba's leaders choose, they will only transform currency distortions into fiscal ones.

CONCLUSIONS: TWO OTHER CHANGES THAT COULD DISAPPOINT

A generational transition in the Cuban government will take place on April 19, 2018. Beyond indications that Miguel Díaz-Canel will be the future president, there are no signals as to who will be vice president or who will direct principal ministries such as the Ministry of the Economy or the Ministry of Foreign Relations. Nor do we know where politicians of the “historic generation” will end up.

The new government will want to demonstrate continuity with the former in order to assure its position with various spheres of political power. It appears that the new government will not have its own economic agenda. We can expect that documents approved by recent Congresses of the Cuban Communist Party—which define the limits of reform, the desired development strategy, and the social and economic model to which Cuba aspires—will continue to serve as economic policy guides.

Whatever the composition of the incoming government, in the short term, Cuba's new leaders will need to convince other state actors that they have the authority and will to, first, achieve the objectives laid out in the “Guidelines for Economic and Social Policy” (Lineamientos), and then deepen the process of reform, overcoming internal forces resistant to change. The new government will thus have to carefully assess the political costs and benefits of implementing reforms to different degrees and at varying speeds, but it will start with low initial political capital due to less popular recognition and a lack of historic legitimacy. Cuba's new leaders, moreover, must confront these challenges at a time of renewed conflict with the U.S. government. The task is by no means easy, and we will have to wait to see how they handle it.

Another change we can expect this year is the publication of new rules governing the operations of the private sector, and thus unfreezing the issuance of licenses. A greater degree of control over tax payments,

as well as efforts to more strongly “bank” the sector, appear to be two basic objectives of the forthcoming rules.

It is very important that the private sector contribute to the Treasury in proportion to its earnings. This is impossible to guarantee if private sector operations are not registered in banks. An effective and progressive tax system provides net dividends to all. The state budget would benefit, exorbitant gaps in income distribution could be avoided, and the societal image of the private sector would be improved. It will be much easier to defeat political and ideological resistance to expansion of the private sector when its income also serves to finance expenses in education and healthcare, and when individual contributions are in line with variable levels of income.

We still do not know if the new rules for the private sector will focus only on fiscal and banking control, or if new policies will address some of the many complaints that the private sector itself has made—high tax rates, the struggle to obtain inputs, and the difficulty of linking operations to foreign trade, for example. A draft of the rules that has circulated does not contain answers to these problems, but rather suggests a focus primarily on more control and penalization.⁶ If the rules that are ultimately implemented do not differ much from what appears in this draft, depleted prospects for the private sector will be the first disappointment Cubans face in 2018.

⁶ See <https://www.reuters.com/article/us-cuba-economy-exclusive/exclusive-cuban-draft-rules-propose-curtailling-fledgling-private-sector-idUSKCN1G700I>