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De-Dollarizing Cuba

Introduction

On October 25, 2004, the Cuban government announced that the dollar was no longer authorized to circulate on the island. It justified this decision as a reaction to the U.S. blockade tightening, in particular as to financial transfers. The de-dollarizing process is a complex, original phenomenon, relatively little studied in the economic literature. It has to be understood in the perspective of the dollarization applied ten years before to be analyzed thoroughly (see Herrera and Nakatani 2002; 2003; 2004). Until November 2004, three currencies were circulating simultaneously in Cuba: the peso (unconvertible), the U.S. dollar, and a convertible peso as the internal equivalent to the dollar. This multiplicity of currencies, associated to a double exchange system (a one-to-one official rate between peso and dollar and a semiofficial one of 26 pesos for $1), translated into a compartmentalization of the economy in distinct monetary circuits with differentiated price structures of similar goods or services. This dollarization was the direct effect of the profound crisis that struck Cuba after 1990 and the Soviet bloc's collapse. Cuban foreign exchanges were protected from hazardous world markets within the Council for Mutual Economic Aid, in privileged conditions (Herrera 2001). From 1990 to 1993, exports and imports fell dramatically, as also did productivity, investment, and consumption. The gross domestic product (GDP) lower point was reached in 1994 ("34 percent in volume with respect to the 1989 level). The increase in fiscal deficit, pushed by state firms' deficit accounts and the political will to limit decreases in wages, employ-

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ment, and social spending, considerably increased the liquidity in circulation and led to a galloping inflation. This trend was amplified by the U.S. blockade and external debt. Consequently, the value of the peso weakened: the average semiofficial exchange rate rose from 7 to 95 pesos per dollar between 1990 and 1994. In this context, the government implemented deep reforms; one of the keys lay in the decriminalization of holding foreign currencies and the circulation of the dollar. The Cuban revolutionary power, constrained to accept dollarization, finally placed it at the very heart of its strategy of recovery. In spite of serious difficulties during the 1990s, this process remained under control and allowed the state recently, despite and because of the blockade's hardening, to begin to de-dollarize. In this paper, we analyze the Cuban dollarization, the transition from dollarization to de-dollarization, and the conditions for a strengthening of de-dollarization at each step of its development.

The Cuban Dollarization

The Supposed Advantages of Dollarization

We know that during the last years, many capitalist countries, especially the developing ones under the International Monetary Fund (IMF) adjustment plans, went through severe financial crises, often caused by capital outflows and speculative attacks on the international financial markets. These crises provoked huge pressures to devaluate their national currencies, involving distortions in internal relative price structures and increasing inflation and high interest rates, thus also increasing external debt. These evolutions make the conditions of their economic growth fragile and are fraught with consequences in terms of unemployment and poverty. On the whole, the very foundations of their economic policies' sovereignty are affected and finally questioned.

The "orthodox" neoclassical economists—and even some "heterodox" ones—traditionally argued about the choice of the "best exchange rate policy" in the era of capital flows liberalization (Lepage and Wajsman 1999). Words also ran high between mainstream economists in the United States about dollarization.[1] Beyond the alternative among fixed or flexible exchange rates (or one of their respective variants), dollarization is more frequently presented as a solution to contain exchange rate instability. Such is the case in Latin America, particularly within the business circles favorable to the Free Trade Agreement of the Americas (FTAA/ALCA). A complete dollarization would allow them to overcome exchange policy constraints. As a renunciation to one's currency, it would suppress the horns of the dilemma of which exchange regime to adopt, as well as the roots of the country's monetary (national) sovereignty.

Nevertheless, it is far from being proved that dollarization constitutes the panacea regarding the monetary and financial stability of dependent peripheral economies. Several recent experiences in Latin America, for example, in Ecuador, Guatemala, and El Salvador, demonstrated that dollarization does not provide internal price stability or stability of the balance of payments' main components, especially foreign capital inflows (Nakatani and Mendonça 2003), and it does not even promote sustainable growth of the productive sectors. It is enough to glance at the events happening recently in Argentina, the most "advanced" Latin American country in this way, to persuade us. In our view, we should not intimate that there are many different economic policy options or that it would be easy for a developing country to liberate itself from the tremendous external constraints in the present globalized world. Our intention is rather to affirm that such options—however restricted they may be—do exist, and that they can effectively be used to meet the interest of the national economy and its people. In other words, the heart of the dollarization matter belongs not only to policy but also, and above all, to politics. The Cuban experience illustrates this argument.

The Use of Dollarization by the Cuban Revolutionary Government

Contrary to the aims of other Latin American countries, the Cuban dollarization aimed to favor foreign currency inflows in order to limit exterior account deficits and to improve import capability, thus avoiding an overly strong depreciation of the peso. The goal of the state was to obtain the means to endeavor to ensure adequate living conditions by smoothing the effects of the crisis. The reforms' main objective were to allow the state to collect the maximum foreign exchange in order to reduce external imbalances, thus to be in a position to do as follows:

1. Maintain, as far as possible, even altered, the Cuban public social system (education, health, access to food distributed by the state, housing, transportation, water, electricity, local telephone, culture, sport at very low prices, etc.)

2. Displace the national economy's reliance on sugar (incomes were declining), toward tourism and nonsugar exports (medical products, nickel, tobacco, sea products, etc.)

3. Endeavor to obtain self-sufficiency in food and the energy sector (by

substituting imports and exploiting new gas and oil fields, respectively)

To reach these goals, the state had to call upon foreign direct investments (FDIs). Though nonnegligible, capital inflows remained insufficient to cover imports required by the country as well as persistent current accounts deficits. Thus, the government adopted a series of monetary steps institutionalizing a partial dollarization of the economy by authorizing receipts of monetary remittances from abroad; decriminalizing foreign currency holding of bank accounts in dollars; and creating retail shops that conducted the sales of consumption goods exclusively in dollars or convertible pesos. Joined with the dismantling of the state monopoly in foreign trade, the dollarizing process intended to put local products in competition with imported goods at international prices, which was supposed to favor a more rational management of public enterprises. Tourism, FDIs, and remittances became the economy's new engines, and the vectors of dollarization, which grew rapidly (CEPAL 1997).

In 1998, private incomes in dollars may have exceeded $1 billion (Escaith 1999?**<<AU: Why question mark? Date OK?>>**).

The effects of this strategy were quite positive on the exchange rate. Strongly depreciated until 1994, the peso's value was quickly reestablished and even stabilized against the dollar (at a twenty-one to one rate) between 1996 and September 11, 2001. By November 2001, due to a general contraction observed in tourism on the world scale, the dollar had slid from 21 to 28 pesos, after which it returned to 26 pesos. It follows that dollarization suffered in Cuba as a de facto situation linked to the disappearance of its old foreign markets, and integrated by its government at the hearth of a set of reforms that consisted of temporarily admitting the use of market mechanisms, albeit strongly regulated. Dollarization occurred along with a mutation of the planning system, which became more decentralized and adopted new monetary tools (Alvarez 2000). Efficient management of liquidity required appropriate regulations: deep changes, carried out in 1997, ended the single bank system by separating its central functions from the commercial and investment ones; a decentralized network of specialized financial institutions has been implemented, ruled by the Central Bank. The latter remains the device's directing organ, under the control of the state.

Positive and Negative Effects of Dollarization

By promoting capital inflows linked to the new growth engines (FDIs, tourism, remittances from abroad), dollarization management strongly contributed to recovery. Undoubtedly, the upholding of the social system was largely due to intersectorial transfers making use of the dual exchange rates: the official one (overevaluated) and a semiofficial one (underevaluated)—none representing the currency's purchasing power. The state's subsidies to public enterprises were reduced and replaced to a large extent by interfirm transfers. Dollarized firms of emerging sectors (tourism, joint ventures, etc.) take advantage of public investments, and they use their management autonomy to allocate the dollars they earned. At the same time, they channel dollars toward the state, by transferring their balance surpluses to a central fund, by collecting wages in dollars of their employees (paid in pesos), or by fiscal means. The sugar sector also contributes to collect dollars for the state, but it does not have the same rights to allocate them; its evolution is still controlled for the best orientation of growth factors toward driving forces. The system was conceived in such a way that the traditional sectors (for example, social services) could finance their purchases of inputs by buying dollars at the central fund at a one-to-one rate. Thus, they are able to provide to people the bulk of their goods or services either free (education, health) or at very low prices (electricity, food, etc.).[2]

Dollarization has also produced a series of effects considered undesirable. It has become entrenched worryingly within the population between those who have and those who do not have access to incomes in dollars, provoking social differentiation, which is judged unacceptable by the revolutionary power. Workers who fulfill essential functions in society (factory workers, physicians, teachers, and so forth) are penalized, because they are paid only in pesos. Acquisition sources of dollars are now relatively varied in Cuba. According to the National Institute of Economic Researches, the 1996 structure of the incomes of the Cuban population in dollars was as follows: 68.1 percent from remittances or tourism, 22.2 percent from non-state sales incomes, 8.2 percent from conversions in exchange markets created for the population, and 1.5 percent from material incentives in convertible pesos (INIE 1997)**<<AU: Provide a complete reference for INIE 1997>>.** The existence of an egalitarian wage structure and of a complete social service system constitutes a success, largely acknowledged at a worldwide level, as well as a key justification of the revolutionary process. Inevitably, the latter is destabilized if most incomes can no longer be based upon labor or a social right. Moreover, incentives to work and to increase labor productivity are thrown into confusion by dollarization. Nevertheless, as almost two thirds of the Cubans now have access to dollars,[3] inequalities are now to be found in the concentration of banking deposits. The emergence of a new social stratum, much richer because they have significant amounts of dollars, exacerbates the internal contradictions, and the increase of these can strengthen antisocialist forces that are hostile to the Cuban revolutionary project. Politically, dollarization is susceptible to generating a certain amount of instability. In such a context, one key of the device implemented by the Cuban state is the strict locker still imposed on private capital accumulation and private wage-earning hiring.

From Dollarization to De-Dollarization

Terms of the Debate on Cuban De-Dollarization

Obviously, the consequences of this monetary reform have not been all positive. Threats it represents to society are such that the state has repeatedly reiterated its wish to suppress it as soon as the conditions will permit it. Then, the question was to agree on what these conditions could be. The Cuban Communist Party expressed its belief of a necessary de-dollarization, as in its *Resolución económica*:

> [W]ithout being unaware of its drawbacks, dollarization of the inter-firms relations has yielded positive net effects, because we succeeded in maintaining the operation of the economy and in reviving its growth, as well as in redynamizing exports and reducing the costs, although to an insufficient extent in the face of our needs and our potentials. This dollarization is not the Cuban economy's normal path and we shall leave it as soon as it will be economically practicle. (Cuba's Communist Party 1997**<<AU: Provide page number>>**)

But part of the population (who gained from dollarization) is not willing to accept the implementation of a de-dollarization of the economy. This obviously hinders politically the course of reforms planned by the government.

Some Cuban early proponents of de-dollarizing formulated original proposals (Carranza, Gutiérrez, and Monreal 1995). Based on the existence of the excess and concentration of liquidity during the crisis, and seen as part of broader reforms (authorizing firms with Cuban private capital), their project aimed at the withdrawal of the dollar along with the convertible peso. Holding dollars would remain legal, but nationals, as well as foreign residents or tourists, would be obliged to use the Cuban peso. The key measure consists of a conversion of all savings accounts and banknotes in circulation into a new currency, according to a sliding, regressive scale: at a one-to-one rate until a given ceiling, and then the more liquid assets held beyond that, the less favorable the conversion rate. In our opinion, such a project raises problems. First, it tries to conciliate authoritarianism of a confiscatory measure against inequalities to liberalism of an opening to private sectors, which would surely cause inverse effects. Thus, the impact could be that of compounding the harmful effects of both advanced steps. Second, confiscation would entail the risk of a drop in confidence toward the state, making problematic its future monetary decisions and inducing bad psychological effects. Third, to be efficient, this reform ought to proceed by surprise; otherwise, it may be difficult to avoid conversions of pesos into dollars and speculative behaviors. And, it would still be incomplete, because intact liquidity would be held outside of the banks.

Another de-dollarizing process could be envisaged in Cuba, which would give the convertible peso a key role during a transitional period. The choice of the convertible peso as a means of circulation instead of U.S. currency would allow for the avoidance of a "race to dollars" and, along with the recovery, allow for a modification of firm subsidy mechanisms and progressively reinforce those of planning in pesos. Such a process would bring advantages, in particular, it would extend control of the exchange market and foreign currency inflows and outflows by the Central Bank; increase the dollars collected by the state; reduce underground exchanges of dollars and misappropriations of merchandise; and attenuate risks of financial crises generated by loans in dollars made by Cuban banks to national firms.

The De-Dollarizing Way Chosen by the Cuban Government

By the Central Bank's Resolution 80 of October 25, 2004, the Cuban government announced that the dollar is not authorized to circulate in Cuba on and after November 8, 2004, justifying its decision as a reaction to the tightening of the U.S. embargo, especially on financial transfers (Herrera 2004). Accordingly, this change in the monetary system is a de-dollarizing process that gives a central role to the convertible peso, a process with which we fully agree (see also Herrera and Nakatani 2004):

1. The dollar will be replaced by the convertible peso, which from now on will be obligatory in all internal commercial transactions, at a one-to-one exchange rate (and with a charge of 10 percent after November 8, 2004).

2. Bank accounts in dollars will be fully available and guaranteed by the Cuban banking system.

3. Remittances from abroad will no longer be accepted in dollars and will have to be made in other foreign currencies.

4. The euro will continue to circulate in the tourist areas.

5. Cuba confirms its will to recover its full monetary sovereignty.

The details of the Cuban policies are not yet known. We propose the following steps as a possible way to implement this de-dollarizing process. In a first step, when the dollar is replaced by the convertible peso as an internal means of circulation, the exchange rate between the two currencies should be kept at one to one for internal transactions. The following measures should be taken:

1. Remittances would continue to be free. Cuban citizens could keep dollars in their possession if they want to, without any restriction, but they would have to exchange them in authorized Cuban banks or exchange offices if they want to make purchases (in shops, restaurants, etc.). All deposits in dollars could be conserved, but all withdrawals would be converted into pesos.

2a. Parallel markets could be "officialized," allowing citizens who own Cuban pesos to convert them against convertible pesos at the market rate. An excess of demand in dollars would cause an increase of its exchange rate and reduce the liquidity. This evolution does not have to affect the national prices, which would be controlled by the state and fixed according to international prices. It would aim at allowing nationals who have reserves in Cuban pesos to make purchases. The fall in the amount of Cuban pesos in circulation or in deposit would reduce the monetary base in pesos.

2b. An alternative way would be to open markets to purchases directly in Cuban pesos. The advantage would be to avoid a "race to dollars" and could accelerate the change in money. A difficulty comes from the variations of prices in Cuban pesos due to exchange rate fluctuations, which could involve applying pressure on rising imports. In this case, tourists could also be authorized to use Cuban pesos.

3. All tourists would have to exchange their foreign currencies into convertible pesos. The conversion would exchange a dollar at a rate of one to one with the peso. The exchange of the euro would be variable, following its exchange rate against the U.S. dollar. Hotels, restaurants, and so forth, would have to convert all their prices in dollars into convertible pesos at a one-to-one rate. To begin, conversions in exchange offices should not involve charges. In the markets that were until now dollarized, all would have to function as if one simply modifies the currency's designation.

4. Foreign firms and internationalized Cuban enterprises should maintain bookkeeping labeled in dollars, at the official rate, and reach a balance between their expenses and receipts in dollars. All dollar inflows to be used in Cuba should be exchanged into convertible pesos. All internal payments should be made in pesos. The entities producing

for the internal market or the cooperatives would keep their present accounting system. Their needs in dollars would be satisfied by the state. All credit balances expressed in dollars would have to be deposited at the Central Bank.

5. The grants of internal credits labeled in dollars by Cuban banks to national firms should be canceled. All credits in dollars already granted would be respected. But, to be renewed, they should have to be converted into pesos. All resources in dollars coming from abroad at the disposal of the Cuban banks would have to be deposited at the Central Bank or converted into pesos to be used in the country. The authorized banks and exchange offices would be able to convert a part of their assets in dollars; its percentage and evolution would be defined and controlled by the Central Bank.

6. The financial system would have to function in convertible pesos. All short-term capital entrances would pass through the Central Bank. All negotiable assets would be exchanged and labeled in pesos. All previously issued certificates of deposits or other financial assets at the origin of a creation of a fictitious capital should be reexamined, and the expanding financial market associated with liberalized short-term capital flows being exposed to speculative attacks, especially in the case of a fixed exchange rate<<AU: Please clarify meaning of sentence>>.

7. The payment of wages would continue to be made in Cuban pesos. Bonuses paid to employees in dollars or convertible pesos should be converted into Cuban pesos.

How to Strengthen the Cuban De-Dollarizing Process: Reinforcing the Peso

If the purpose of this first step is to suppress the internal circulation of dollars, the dollar should maintain its role of a reserve of value for the Cubans. Cubans could keep their dollars at home or deposit them in domestic banks. Furthermore, transactions made in dollars by firms and banks in their internal operations would have to be eliminated. The de-dollarizing timetable has to be strictly determined by the amounts of foreign currencies at the disposal of the Central Bank. This point is crucial to guarantee the convertible peso's internal circulation, external account balancing, and the increasing capabilities of external payments. In the second step of this process, one of the two currencies remaining in circulation, convertible peso and Cuban peso, would have to disappear. Taken as a measure of value, the convertible peso expresses the level and dynamics of the factor productivity in the United States, as compared to that of the rest of the world. On the contrary, the Cuban peso should express the level and dynamics of Cuban inner productivity—even with a price structure modified by planning, as well as by specific historical or structural factors. In our opinion, the Cuban peso has to be chosen as the sole currency in use on the domestic markets. To this end, the following measures should be adopted:

1. All prices in shops, hotels, restaurants, and so forth, would have to be converted into Cuban pesos, at the current rate in force the day of the abandonment of the convertible peso. Thus, Cubans and foreigners would use the same currency for all their transactions on national territory. The Central Bank would have to be in a position to maintain the exchange rate stability—without adopting a policy of fixed rate that is too rigid.

2. All credits and assets of banks and enterprises, expressed in convertible pesos, would have to be converted into Cuban pesos at the same exchange rate. Expenses and receipts accounting of all internationalized Cuban entities should be maintained.

3. In this framework, the Central Bank's role, strongly reinforced, would consist of controlling all deposits as well as international reserves in dollars, in euros, and in all other foreign currencies; issuing and controlling the monetary base; supervising the banking system, the expansion of internal credits in Cuban pesos, and the interbank credit market; regulating the development of the internal monetary capital; functioning as lender of last resort; and providing surety for the Cubans' deposits in demand as well as saving accounts.

Thus, the exchange policy adopted by the Cuban government would allow it to strictly control capital flows in order to avoid both the entrance of speculative foreign capital and the risks of speculative behaviors within the domestic banking system. Consequently, this scheme would differ from that applied by the capitalist countries, where the interests of dominant world capital prevail over any other consideration. As a matter of fact, the liberalization of financial flows has involved a very strong volatility of the international exchange markets. There are no longer policies that allow a capitalist economy, even at the center of the world system, to secure the stability of the exchange rate of its national currency. Henceforth, every country is open to speculative attacks against its currency, likely to provoke a financial crisis.

Conclusion

The difficulties and risks inherent in the de-dollarizing process are far from being negligible. A first difficulty comes from the amount of foreign currencies necessary to meet the needs of converting Cuban pesos and the import demand. A second difficulty is to set the exchange rate and the relations between internal and external price structures. After years of experience in managing the convertible peso, these variables (exchange rate, prices in dollars and domestic prices) can be assumed to establish a compatibility among themselves. A third difficulty is linked to the reform's distributive neutrality. As de-dollarizing involves resource transfers toward the state, it is desirable to develop income redistribution mechanisms, especially by improving the quantity (and the quality) of the goods in the consumption basket guaranteed by the state to all Cubans (*libreta*). If the use of saved Cuban pesos for consumption of imported goods can lead to losses due to their devaluation, all other operations have to be neutral. A last difficulty will be to convince the people of the importance of de-dollarizing as a means to reinforce the economy's planning mechanisms. The main risk lies in a potential reluctance to de-dollarization. Inside Cuba, the opposition could provoke a race to dollars, depletion of the reserves, and a devaluation of the Cuban peso, but such an option entails some risks of losses for those who would participate in this race. An opposition by foreign banks and firms appears to be a much more serious risk. Nevertheless, the latter could be averted if the Cuban state gives to these foreigners the guarantee that they will not suffer any loss during the de-dollarizing process.

Notes

1. Some authors in favor of dollarization include Berg and Borenzstein (2000), IEEP (2000), Hanke and Schuler (2001), and Schuler (2002). Some others against dollarization include Acosta (2002) and Morandi, Mendonça, and Nakatani (2002).
2. On some problems created by dollarization on social services, see Ferriol (2004: 64)**<<AU: Provide a complete reference for Ferriol 2004>>**.
3. INIE cf. Angela, p. 64**<<AU: Provide a complete reference and year>>**.

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