

# A CONCEPTUAL SKETCH OF THE NEW FINANCIAL AND DEVELOPMENT INSTITUTIONS FOR THE CUBA IN TRANSITION AND THE FUTURE CUBA

Alberto Luzárraga

The title of this paper reveals its content. The lack of concrete facts on the Cuban economy, particularly the State deficit and that of its enterprises, renders a serious quantitative analysis an almost impossible job. It is best then to work on a conceptual level. Common sense and the experiences of other countries should allow us to reach some logical conclusions.

To start let us say that the financial work to be done has to be governed by the concept of *Reconstruction*. Only as this process advances may we consider financial transactions normal and commonplace. "Ab initio" we must think of a hybrid state of affairs where public, private and semi-public entities will co-exist. The design of banking legislation, including a Central Bank law, rules and regulations, etc., is a laborious and indispensable assignment, but not extremely difficult as this subject is well studied and adaptation to the Cuban reality is all that is required. The difficult assignment will be to diagnose the depth of the Cuban problem and to provide a balanced and forward looking remedy that avoids the excesses and mistakes we have seen elsewhere.

Let us accept then that the reconstruction will be truly the work of Romans, particularly if one includes the worthy objective of cooperating to make the Cuban people the owner of the fruit of its labor. This latter concept merits emphasis. The Cubans in the island must be integrated quickly to a normal life and be able to feel that they own something including

stock ownership of the company for which they work. Many models may be designed but the objective is the same: to bond and to give incentives. This is indispensable in order to promote social peace and is also the best vaccine available to counter 35 years of brainwashing.

If all that Cubans can aspire to is to be mere employees of a foreign company or of companies controlled by Cuban exiled capital, we will have created an excellent prescription for the demagogues. They will then be able to exploit comfortably the owner versus proletarian antagonism that underlies the Marxist rhetoric and indeed human nature in general.

We must open new avenues to channel the energy and aspirations of the Cuban people through institutions that facilitate a better future, and thus insure a process of social cohesion and national unity directed to a common objective: the peaceful reconstruction of Cuba. As I see it the former is not just a beautiful ideal but an eminently practical objective. Without social peace, investment will not take place and Cuba will not be an attractive country to live in. Thus, the exile community has the unavoidable duty to think first on how to *reconstruct*, which is not the same as to *regain* its property. A well directed reconstruction will furnish great opportunities to all those that want to work, invest and even regain property, but through consensual and juridical processes, where there is agreement amongst the parties.

A successful reconstruction process requires patience, flexibility and the will to make mutual concessions in order to create a new reality that may be first viable and second better than the one that preceded it. Japan and Germany are two good examples.

Since space and time do not allow a detailed analysis, let us then examine the most pressing financial problems and sketch possible solutions. A warning is in order: Banking is only the reflection of the society in which it operates and will not function efficiently in the transitional Cuba unless many problems are solved a priori.

### Central Bank

Cuba's Central Bank must be independent if it is to be useful. However, in the beginning it must work very closely with the Cuban Treasury as it will need to walk a tightrope to take care of transfer payments and the deficits of the state enterprises; and all of this without unleashing a galloping inflation. The Central Bank cannot issue without limit.

This is an appropriate moment to make a general consideration applicable to the whole reconstruction effort. State deficits cannot be absorbed financially unless successful private businesses exist, earn profits and pay taxes. The financial problem has to be seen as a whole. The disastrous business of agrarian and industrial socialism has to be dismantled and substituted by a profitable normality. This profitable normality shall be obtained more quickly in certain sectors, as tourism, that must finance the reconstruction of the more complicated sectors, such as the sugar industry.

The process will require an open and free foreign exchange policy with a free flotation of the peso. There is no other choice for an exporting country that will maintain close relations with a vast community located in the United States. Mexico, with a similar situation, attempted an exchange control and we know the result, it lasted less than a year. An exchange control in Cuba will only result in a black market, absurd and inefficient rationing of imports and in a source of scandals and corruption. This is not a gratuitous statement. I have observed this phenomenon

for 30 years in Latin America and only now (finally) has it been dismantled.

### PRIVATE VERSUS STATE BANKING

There are no great doubts here. The banking system must be private if it is to effectively serve depositors and borrowers. The supervision of public banking more often than not suffers from political interference that eventually degenerates into favoritism and, in the worst of cases, in the purchase and sale of influence. Experience shows that a good part of the State Banks fail "de facto" if not "de jure" and that the State must replenish their capital.

However, initially in Cuba one must be prepared to accept the coexistence of private banks with certain specialized entities necessary for the reconstruction process. The need arises simply because many of the risks will not be suitable for private commercial banks due to the fact that an information base for the borrowers, as well as competent management, legislation, courts, etc., will not be created overnight, and in the meantime the country cannot remain at a standstill.

The special entities that will be mentioned later may assume higher risks than the private banks, but must have a common denominator, i.e. the presence of independent private persons in their boards and a limited term established by law after which they would be liquidated. And this, to avoid the creation of bureaucratic monsters that would intervene in everything, restraining liberty and the rights of citizens. *They must be transitional entities, period.* Some entities such as Development Banks may be useful at a later stage, but in that case a specific new approval should be required and private capital should participate in some measure in order to insure a balanced operation.

One could then ask: what is the function of the private banks? The answer is: The most ample one that can possibly be authorized within a strict system of supervision and regulation focused on what are capital risks and what are loan risks.

At the inception of a transition Cuba cannot allow itself the luxury of authorizing a multitude of poorly capitalized commercial banks that may lend impru-

dently and fail with the attendant loss to their depositors. The effect on a population that would only then be emerging from Marxist arbitrariness would be as devastating as it is unacceptable. Some will say that deposit insurance would solve this problem but this is not really true. If deposit insurance is extended to all banks without strict criteria as to quality of management, capitalization, etc., we will witness the same phenomenon that has taken place elsewhere, i.e. the proliferation of banks often managed by incompetent people or, in the worst case, people with low moral standards. Banking is a concession to invest other people's money and the state cannot offer its guarantee to everybody.

Deposit insurance would have to be very demanding as to who may deserve it and who is worthy of continuing to have it and at what price. This approach may solve a problem but may create another one, i.e. the concentration of banking in entities that are very well capitalized, and that probably would be mostly foreign owned. From a purely technical standpoint some will say this is irrelevant. But it is not convenient for a country to depend almost a 100% on foreign entities in an industry as essential as banking; particularly a country such as Cuba that has seen itself subject to the insistent exaltation of its nationalism, with political ends if you wish, but perhaps with the beneficial effect (provided it is constructively channeled) of the consolidation of its national identity.

In any case, the answer to the dilemma is not an antiquated and inoperative market reserve à la Mexico that would fall by its own weight, but a gradual opening where licenses are granted to all the foreign banks that had one prior to 1959 or to new ones in the absence of those, and to the well capitalized Cuban banks that have competent personnel. In this last case, the association of Cuban capital and of Cuban capital with that of foreigners is a sensible answer. The by-laws of Cuban/foreign capitalized entities could have well known provisions that will ensure the agreement of the Cuban nationals for certain management decisions.

As the disaster is remedied new licenses can be granted and deposits will flow from the public sector to

the private sector. There is really no other way. In Cuba the ratio of money to Gross Domestic Product is so low that it is not enough to allow many banks to function. The Cuban people must have first a stable currency and second earn enough to be able to save and invest. Without saving, investment and private companies there cannot be a private banking system that is worthy of its name as it would lack the necessary diversification of loans and deposits. Experience shows that banks fail due to loan concentrations with a few borrowers as well as by liquidity crises brought about by a badly diversified deposit base. Bank regulators all over the world are aware of this fact, but what they cannot do is to control the problem if the market does not of itself furnish the necessary diversification.

Add to this the need to create commercial legislation, impartial courts and the training of competent bank regulators and it is easy to see that commercial private banking cannot but follow the national course of the privatization of the economy, assuming in a gradual form the financial activity that at inception must be accomplished by specialized financial entities and this only as worthy borrowers emerge.

What one could authorize with broader criteria is the operation of investment banks as long as they operate with their own capital, that is risk capital, as in the end this is what the country needs. At the beginning of the process most of the transactions (perhaps with the exception of exports) are going to be risk capital and thereby not suitable for commercial banks lending depositors' money.

### **MUTUAL FUNDS—STOCK MARKET**

This is a topic that raises a keen interest due to its success in the United States and other markets. Mutual funds are an excellent conduit to raise capital and privatize, but at the inception of the process their sale to the Cuban public and commercial banks (as opposed to investment banks) should be strictly regulated. The excesses and frauds that have taken place in Russia and elsewhere, taking advantage of the public's ignorance, should not be repeated in Cuba. On the other hand, the participation of the Cuban people in stock ownership of new and privatized companies is very desirable. In the latter the preferred meth-

od, although not the only one, should be the soft loan amortized through salary withholdings and with the prohibition to sell the shares for a certain period in order to avoid premature sale due to ignorance. This has functioned well in Chile and has the advantage of creating a supply of stock that in the future could be acquired by the mutual funds. The objective must be to create a sound mutual fund industry even if it takes longer.

Needless to say, the mutual funds industry is dependent on the existence of a stock market with the proper regulations and personnel. The topic needs separate treatment. Suffice to say that this is yet another institution to be designed soundly and allowed to operate only as a trustworthy information base becomes available.

#### **SOCIAL SECURITY—PENSION FUNDS — HEALTH CARE**

This is another monumental financial problem inasmuch as the Cuban State does not have enough funds to run the system and pay reasonable salaries and benefits. The issue is so vast that we will only attempt to put it in a financial conceptual frame. Withholding at the source would have to be implemented combined with the employers' participation. The deficit must be absorbed with public funds until the retirement funds are viable and can be reverted to the private sector a la Chile. The same can be said about health care. We will have to revert in part to HMO's and mutualist associations, but in the meantime expenses must be met.

All of the above implies public financing and this affects the banking industry. It will have to voluntarily purchase government bonds or accept a system of directed investment. Certainly not an ideal solution, but a common one in crisis situations which brings forth vividly how complicated the beginning of banking in Cuba will be. There will be many needs to be addressed, few sources of money and as we said before, the Central Bank cannot issue without limits.

#### **SPECIAL ENTITIES BY SECTORS**

##### **Housing**

Cuba's housing deficit is well known. Worse, we know that the existing housing stock is in a state of

disrepair. If the Cubans of the island lack adequate housing, needless to say that if the exiles wanted to go and live there tomorrow they would have to be content with a prolonged "camping" experience. There is simply no room for so many.

The problem has two solutions; new construction and repair of the existing housing stock. But as we know all existing housing is occupied and much of it has its original owner living in exile. A logical question would be: How can one conciliate the rights of the original owners with the possession by a third party that in many cases has been told by the government that he is the owner though the payment of rents? There is a possible solution and it is the creation of a *Bank for the Reconstruction of Real Estate Property* that would do two things:

- a. Facilitate the reconstruction of existing housing.
- b. Construct new housing.

However objective (b) would be linked to objective (a). The person that wishes to recoup and reconstruct his original house, now occupied by a third party, could do it on the basis that the Bank would furnish a new house or apartment to the occupant giving him a priority. This priority would be justified by the contribution of foreign currency by the person paying for the restoration. In that way, a constructive activity would be fostered, i.e. find an exiled Cuban willing to do such a transaction.

The financial engineering design, sources of capital for the Bank's deposits, etc. is not the subject of this paper. Suffice to say that the design is feasible and that it can be done without massive monetary issuance.

##### **Agrarian Problem - Financial Impact**

There are two problems. The sugar problem with characteristics of industrial reconversion and the general agrarian problem centered on the property of land and diversification of crops.

Many years before Fernando Ortíz wrote his famous "*Cuban Counterpoint of Sugar and Tobacco*" the topic of diversification was in vogue. Much had been done in the fifties. Cuba exported winter fruits and vegetables to the United States (today a big business), was

almost self sufficient in rice, etc. The regime threw us back to the days of a one crop economy, and committed Cuba to the role of sugar bowl for the communist bloc. And of course without the slightest regard for costs.

The present system of harvesting cane is very deficient and results in very poor saccharose yields. Add the obsolescence of the industrial plant and compare then Cuba's situation to that of other sugar producing countries that:

- a. Protect their internal prices.
- b. Are better equipped industrially.

Further, most countries with acceptable rainfall produce beet or cane sugar. The export sugar industry is in a good part a marginal industry that offsets the deficits produced by unpredictable climate related events. This means that in the future Cuba there will be no role for inefficient sugar mills that produce at costs in excess of the world market price. It is well known that Cuba has optimal conditions for the growing of sugar cane. The sugar industry will always play an important role in the economy but it cannot exist as a subsidized activity that generates huge deficits to be covered by monetary issuance. This would unleash a vicious circle of issuance-inflation at a prohibitive cost for the country.

The post-Trujillo experience in Santo Domingo is indicative. Therefore, Cuba must create an *Institute of Reconversion and Return to Private Management of the Sugar Industry*. The Institute must attack the economic-financial problem coordinating with the Central Bank and the Ministry of Finance and do the following:

- a. Determine the optimum size of the industry.
- b. Determine which units are obsolete and which can produce more efficiently.
- c. Develop a transition plan in order to place excess workers and pay them an unemployment benefit during this period.
- d. Develop an agricultural plan determining the supply roles, ownership and possession of land and cane price as a percentage of its sugar con-

tent, taking into account the maximum extension of land that a country with a relatively small territory can dedicate to this crop. A new version of the "*Ley de Coordinación Azucarera*"? Perhaps it would be the best solution.

- e. Develop the financial plan.

The financial component of the process is as vast as it is difficult. The state must pay the wages of excess personnel until they find gainful employment, and it will have to absorb operating losses until the units go back to the private sector. For bankrupt units to go back to the private sector it is necessary first to clean them up. Nobody is going to pay for past losses. This has been the experience in other countries.

What we can foresee in the sugar sector is a classic investment banking activity where the units go to those that can guarantee an adequate operation of the business. Here we face a difficult problem of conciliation of interests. There are valid claims of United States citizens properly registered, as well as the rights of Cuban nationals who suffered confiscations. But the problem is complicated because without cane there are no mills, without mills there is no cane and without peace in the possession of land and people to work it, there is nothing. It is the classic difficulty of an agro-industrial business that faces the challenges of both activities.

The issue must be viewed as a whole. Harmonic solutions must be found which may result in many combinations, including the association of the owners with new investors or with labor, the return of the units to the old owners that can operate them or proper and viable compensation if the former is not possible. The details of how to do this are not the subject of this paper, suffice it to say that in all probability certain basic criteria imposed by reality will exist, namely:

- a. Need to produce at an internationally competitive cost and therefore to create healthy industries that can be of interest to the private sector.
- b. Need to provide juridical safety to new investors, and to conciliate the interests of growers, workers, mill owners through a fair system.

- c. Need to find ways to finance the industrial conversion.

I feel this is feasible albeit complex. Without juridical stability and industrial peace the banks are not going to be very keen on doing much. Assume we obtain both things. Then we must determine if there is a capital base upon which one may grant credits and more importantly, is there sufficient cash flow? Loans are paid with cash flow and not with liens. The value of liens is a function of the productivity of the business. Banks are not going to be interested in foreclosures in a country in transition. A lien on produced sugar can be a good source of loans, but if there are operating losses these loans solve nothing. The losses must be covered and eventually the same result obtains, insolvency and foreclosure in more or less time.

I repeat, the only solution is: Clean up the industry, bring in new capital and then loans are feasible. If there are doubts I would invite you to study the processes of industrial reconversion in Europe and Latin America. There are no brilliant inventions in these matters. Accounts balance or they don't balance.

### Other Industrial Sectors

Concurrent with the handling of the sugar problem, Cuba must create a financial institution dedicated to develop other crops with high export potential as well as those necessary for the sustenance of the population. Cattle ranching must also be included.

Export sectors that have competitive advantages are:

- a. Citrus
- b. Tropical fruits and winter vegetables.
- c. Tobacco
- d. Light manufactures derived from agriculture

Compared to the sugar problem this is a less difficult challenge. Land and climate are the main factors and investment in equipment is much smaller per production unit. The main issue here is how to create a viable borrower. The present government is organizing cooperatives and they will have to be reckoned with, without forgetting that generally the best farmer is the one that owns his land.

Today there exists a small base of private farmers. We should begin right there, supporting the best so that they extend their arable land and production. Let us emphasize that agriculture and/or cattle lending requires constant attention. Here, cash flow can evaporate quickly if there is a lack of care to the day to day needs of crops and cattle, not to mention climate which may change everything. A team of agronomists that supervise the investment of loan process is essential. Agricultural loan programs do not work with bankers sitting in their offices listening to their clients. Fortunately Cuba has many agronomists, frustrated by the insanity of the past, that could find here useful employment. The organization and funding of the agricultural financial sector can follow many models, including an important role for credit cooperatives.

### Industrial Reconversion (excluding Sugar Industry)

A Bank or *Institute of Reconversion of Industry and Mining* must support this process and do the following:

- a. Close the obsolete loss leader industries created by the government and
- b. Sell the viable ones to private enterprise.
- c. Return to its owners the industries that can operate efficiently provided the owners have economic and management capacity. If they lack it, they could form partnerships with those that have it or receive the compensation that is appropriate and viable. Within this process, the participation of workers in the stock ownership of companies should be promoted by reserving, when viable, a portion of the capital that could be paid with a soft loan a la Chile. Undoubtedly, this idea will be criticized by some but, if well managed, it should facilitate rather than hinder the privatization process. What should remain clear is that management must be independent and that one or more control shareholders must exist. Otherwise we are dealing with utopia.
- d. Develop a general plan to start new industries facilitating their creation and operation. Cuba has a great future in service industries (tourism aside)

such as informatics, data processing, offshore banking (really the province of the Central Bank), distribution and warehousing centers, as well as those that provide added value, i.e., maquila, etc.

Service and added-value industries create many jobs and at inception should be the engine that propels a good part of the economy. Within this special entity, tourism merits a discrete organization. Cuba's privileged geographic location, its beaches, natural beauty and climate are a coveted asset in a world with a limited availability of such resources. Therefore, one of the first things to do is to revise all the abusive and disadvantageous agreements that have been made, and place at auction at a fair price that which has been sold or given as a concession for very little. And let us not even speak now of the labor claims that should and must arise due to the ridiculous salaries paid to the workers of this sector by those that exploit tourism. Karl Marx would blush at the present scheme which by the way extends also to mining and industry in general.

### EXTERNAL DEBT

A quick reference is in order due to the debt's financial impact. A special section of the Ministry of Finance must be created so that it, together with the Central Bank, may handle the task of renegotiating the debt.

Cuba is probably the country with the highest per capita debt in the world. The political-economic debt with Russia is unpayable in its greatest part, and Russia knows this well enough. The debt with other Western countries that lent, very imprudently, to the Marxist outpost in the Americas must suffer a much greater discount than the one granted to Mexico, Poland, Brazil, etc. Cuba will have to pay something but on very, very comfortable terms. The creditors know it, and the only reason for settling this matter is to normalize commercial relations so that Cuba may earn enough to pay what is agreed to and obtain a positive commercial balance.

As to the conversions of debt into capital effected with some of our neighbors in the American continent and with others, a careful revision is in order.

We must apply the same principles of valuation of assets and transparency that were applied by those countries when they accepted debt conversions. This is fair and just. Sales at very low prices and without transparency or with pressure can be nullified according to all the civil codes of the world.

### CONCLUSION

The present Cuban government is attempting reform and has announced drastic measures, such as the firing of 800,000 workers that will receive up to 60% of their meager salaries (for a limited time), provided they are not suitable for agricultural work. This is really tragic. The application of harsh measures without incentives to the population, and without the massive capital infusions that are generally only available from investors that would demand the guarantees offered by the Rule of Law, are not going to produce great results.

The financial problems that we have described are of such enormity that a satisfactory resolution cannot be anticipated without the participation of capital that has a long term development objective rather than short-term exploitation. The investors that Cuba needs will only invest if there exist clear rules of the game that cannot be changed by one or a few people without transparency or accountability.

Today's joint ventures pay salaries in dollars to the Cuban State for the workers that the State furnishes, allowing it to earn an exchange differential as the Cuban government pays the workers in pesos. It would seem that the Cuban government learned well the lesson of the "plusvalía" that Marx so harshly criticized. Economically speaking, the policy is clumsy. Miserly salaries do not allow for consumption, without it there is no internal market and without the internal market, the capital of many investors will never arrive.

The model as designed is only good for a plantation economy focused on exports and on cheap and harshly controlled labor. In itself it is a very fragile design. Many export businesses need the support of the internal markets to cover costs which then allows them to compete internationally at good prices. Further, cheap labor is the weakest of competitive advan-

tages in a world where technology, marketing skills, state of the art equipment, etc., are crucial. The hope of Cuba's government is that the United States blockade will be lifted and that the U.S. consumers will be content to buy products made by slave labor only 90 miles away. I believe they misjudge greatly the good instincts and fairness of the American people.

Cuba is losing the best part of the process of change while implementing a regressive policy, wherein it demands sacrifice without providing means to make it worthwhile. The so called "opening" has all the characteristics of an operation to gain time and hold on to absolute power for a few more years. No doubt, many thoughtful and capable people that work in the administrative apparatus of the regime see this and know that in the end things must be different, that brute force and productivity do not march hand in hand, but circumstances prevent them from speaking out. Further, the regime manages skillfully the old adage "après moi, le deluge" . . . and it doesn't have to be that way because the immense majority of the exiled Cubans want to see Cuba prosper peacefully.

This is why I close with a thought for all. *For Cuba to progress we must unite the Cubans that lost their land to preserve their liberty with those that kept their land but lost their liberty.* This can only be obtained within a State subject to the Rule of Law, with independent courts, a freely elected Congress that legislates for the good of its constituents and not against them and by an elected executive that respects the law.

In any case, like it or not, the blinding pride of those that do not want to yield anything or yield only the strictly necessary will fail, because the aspiration to liberty is irrepressible and then, with optimism and energy we may work together to create a Cuba "With all and for the good of all."

## SUMMARY

The paper attempts to present a conceptual sketch of the financial problems facing the post-Castro Cuba, and to present possible solutions.

An attempt is made to outline practical alternatives based on the author's experience of investing and running businesses in Latin American economies that have gone through similar processes.

To be practical one must have both feet firmly anchored in reality and this includes the social and historical reality of Cuba. In this context it is imperative to bring the people of Cuba into the reconstruction process fully and enthusiastically. The latter can only be obtained by allowing them to participate as much as possible in the ownership of the new enterprises to be created. as has been done in the one Latin American country that has attained the greatest degree of success and social stability, i.e. Chile.

Social peace is indispensable for reconstruction. To attain it will require great flexibility, imagination coupled to the willingness to work patiently and create a number of transitional institutions. Of necessity this will mean a radical change vis a vis the status quo ante.

Castro's scheme for a plantation economy where he is foreman for life and where selected foreign partners exploit the Cuban people is reactionary. However, a mitigated version of the same shrouded by the cloak of a weak democracy and tainted capitalism a la Russia is also reactionary, and does not constitute a viable alternative. Cuba must be Cuba, break the vicious circle of tyranny/liberty that has plagued its history and finally become a country — "Con todos y para el bien de todos" — "With all and for the good of all."