Cuban Integrated Financing Framework (CIFFRA)

Policy Note No. 9
Identification of Risks

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Identification of risks

In a world of increasing uncertainty regarding the evolution of economic, political, social, environmental and health variables, the identification of risks is of particular relevance to anticipate, to the extent possible, potential events that could deviate the development financing strategy roadmap from its original goals. As part of the Joint Program “Support for the development of an Integrated National Financing Framework for the SDGs in Cuba” (CIFFRA), a preliminary report was prepared to help policy makers better understand sustainable development financing risks in Cuba.

Several methodologies are used worldwide for the identification of these risks, which are usually based on quantitative exercises (financial, real, fiscal, external risks, etc.). However, in Cuba there is no tradition of carrying out these exercises, given that it does not belong to the main international organizations that undertake these studies. In addition, quantitative exercises are currently biased by changes in the level and structure of statistical series, given the impact of the Monetary Overhaul on national accounts.

Against this backdrop, a risk perception exercise was carried out by applying a questionnaire to a sample of 30 experts on development financing policies in Cuba.[1] Box 1 shows the eight main risks identified, ranked according to the degree of relevance assigned by the experts.

Box 1
Cuba: risks identified and prioritized by experts (from highest to lowest relevance)

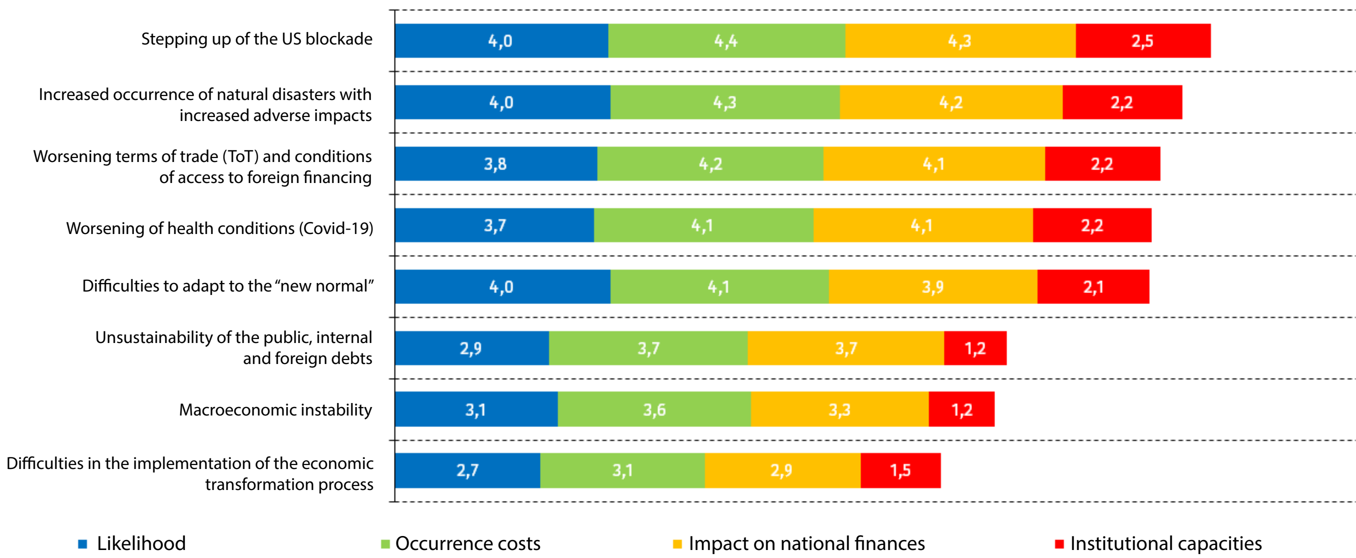
1. Increased occurrence of natural disasters with increased adverse impacts
2. Difficulties in adapting to the “new normal”
3. Stepping up of the US blockade
4. Worsening terms of trade (ToT) and conditions of access to foreign financing
5. Worsening of health conditions (Covid-19)
6. Unsustainability of the public, internal and foreign debts
7. Macroeconomic instability
8. Difficulties in the implementation of the economic transformation process

Source: Authors.

[1] Of the respondents, 18 are civil servants, 10 are academics, 1 is a state-owned businessman and 1 is a private businessman. All are university graduates, while 15 have a higher academic degree. Women represent 40% and the average age is 49 years old.

Some experts assessed other possible risks that should be considered by authorities: (i) loss of young and skilled labor force due to increased migration; (ii) population aging; (iii) dollarization of the economy; (iv) high fiscal and quasi-fiscal deficits; (v) high level of centralization of external finances; and (vi) quality of development projections and projects to be financed. Figure 1 shows the sum of average ratings for each risk resulting from the application of the questionnaire: likelihood of occurrence, occurrence costs, impact on national finances and authorities' management capacity. The values express evaluations from 1 to 5 for each risk according to each of these criteria.[2]

Figure 1
Cuba: risk assessment by experts



Fuente: Elaboración propia.

It is thus evident that the development financing strategy in Cuba is highly vulnerable, due to three fundamental facts:

(i) The main risks are linked to exogenous variables beyond Cuban authorities' control (i.e., economic blockade, natural disasters, worsening of the terms of trade and adaptation to the "new normal"). However, public policies could contribute to better adapt to the new normal, while fostering growth and diversifying exports could reduce the risk of deterioration of the terms of trade.

(ii) The variables over which the government has greater control provide limited leeway as the current scenario already shows a significant deterioration of these indicators: (i) high levels of foreign debt, which make it difficult to meet international commitments and hinder renegotiation or restructuring efforts; and (ii) macroeconomic instability, especially in the last year (high inflation, partial dollarization, depreciation of the Cuban peso, high fiscal deficits), as additional pressures on the sustainability of public debt and the implementation of the economic model update process.

[2] Likelihood of occurrence: 1. Very unlikely, 2. Unlikely; 3 Likely; 4 Very Likely; 5. Almost certain; Occurrence costs: 1. Minimal, 2. Slight, 3. Moderate, 4. High, and 5. Very high. Institutional capacities: 1. minimum, 2. reduced, 3. medium, 4. high, and 5. very high (for this indicator the score in the graph equals 5 minus the assessment, so as to correspond with the other indicators: the higher the value, the higher the risk).

(iii) On average (see footnote 2), risks are very likely to occur, the costs their occurrence would entail are significant, their impact on national finances (public finances, financial system, foreign debt, foreign exchange earnings and development financing) is high, and institutional capacities to mitigate these risks are average.

Therefore, it is necessary to incorporate a risk mitigation strategy into the Cuban Integrated National Financing Framework, aimed at: (i) developing instruments to minimize, to the extent possible, the impact of existing risks; (ii) preventing the strategy itself creates new risks; and (iii) promoting greater resilience to emerging risks. As part of the questionnaire, experts identified risk mitigation opportunities and made risk mitigation proposals, which do not represent a strategy; but serve as input for the subsequent development thereof, as part of CIFFRA.

Among said opportunities, the following stand out: (i) political will and consensus reached to undertake far-reaching transformations; (ii) potential of crises as catalysts for pending transformations; (iii) newly approved transformations (state enterprise and agricultural sector streamlining, creation of MSMEs and boost to local development); (iv) working system of Macroprograms; (v) progressive national and international recovery from the Covid-19 crisis; (vi) capacity of the health and biopharmaceutical system in the current context; (vii) capacity of the human capital trained by the educational system; (viii) Cuban emigrants with capital and wishes to invest in the country; and (ix) favorable regional geopolitical context for integration.

Proposals include: (i) renegotiating the foreign debt through flexible and innovative mechanisms; (ii) updating public finance management; (iii) redesigning investment policy and increasing its efficiency according to the current context; (iv) continuing the Monetary Overhaul process (giving greater prominence to price and market signals); (v) consolidating binding macroeconomic coordination mechanisms; (vi) promoting competition, and diversification within and the update of the financial system; (vii) updating existing regulations to attract FDI and for foreign trade; (viii) strengthen capacity building in public institutions; (ix) promoting investment and technical and financial development in the biopharmaceutical industry; and (x) promoting the search for soft financing through multilateral mechanisms.

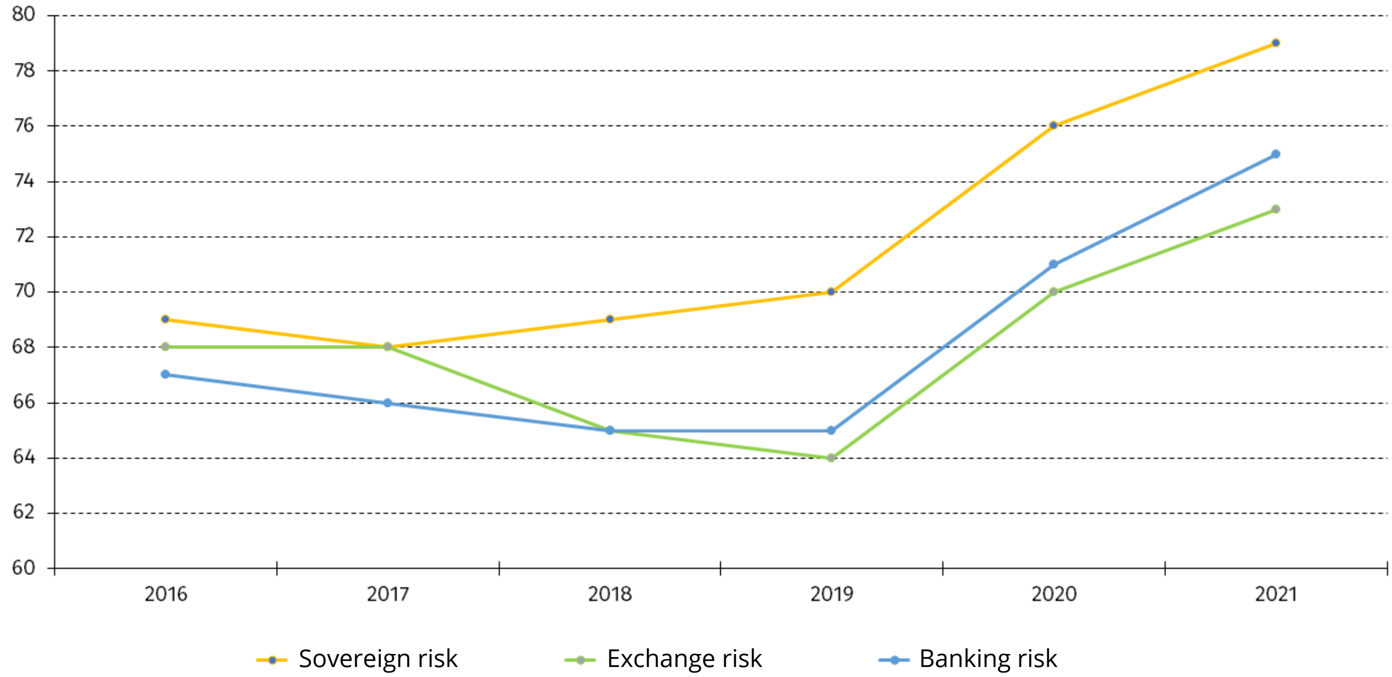
As a complement to the questionnaire, a review of the most systematic external report on Cuba's credit risk[3] was carried out. According to the EIU (2021),[4] the country has the second lowest credit risk assessment in the region (CC),[5] only outranked by the Bolivarian Republic of Venezuela (C), which, after all, was to be expected, due to the stepping up of U.S. sanctions and the particularly restrictive environment imposed by the Covid-19 pandemic. It is also consistent with other assessments of the Cuban macroeconomic environment, which highlight the country's difficulty in accessing international financial markets. Figure 2 shows a worsening of the three indicators that make up this index in the last two years: sovereign risk, foreign exchange risk and banking risk.

[3] *The Economist Intelligence Unit* (EIU), Cuba, 2021 [online] http://country.eiu.com/cuba.

[4] Five criteria are evaluated: (i) sovereign risk, (ii) foreign exchange risk, (iii) banking sector risk, (iv) political risk, and (v) structural risk. Country risk is the simple average of the scores of the first three risks.

[5] In 2022 Moody's rating for Cuba is Caa2 (very high credit risk), outranked only by Belize, Ecuador and Suriname. See: https://repositorio.cepal.org/bitstream/handle/11362/47514/1/S2100894_en.pdf.

Figure 2
Credit assessment of Cuba, according to EIU, 2016-2021



Source: Author, on the basis of The Economist Intelligence Unit (EIU), Cuba 2021 [online] http://country.eiu.com/cuba.

Disregarding possible analytical biases related to information problems, the EIU assessment (2021) reaffirms: (i) the relevance of foreign debt as one of the main restrictions to development financing in Cuba;[6] and (ii) the weight on certain risks, such as the exchange risk, of the difficulties in implementing key transformations.

In summary, Cuba's development financing strategy is particularly sensitive to the impact of exogenous risks with a high likelihood of occurrence and high occurrence costs. The government also has limited leeway to manage and mitigate endogenous risks. Foreign debt is reaffirmed as one of the main restrictions to development financing in Cuba, as well as the need to evaluate unexplored traditional and alternative mechanisms to mitigate multiple risks.

The vulnerability of the development financing strategy evinces the need to develop risk monitoring tools: (i) expand the application of the questionnaire (increase the number and diversity of respondents); (ii) promote the regular use of this or other questionnaires to study the evolution of stakeholders' risk perception; and (iii) advance in the design of quantitative tools for monitoring macrofinancial risks (public debt, macroeconomic stability, financial stability, country risk).

CIFFRA Technical Committee
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[6] Beyond a potential risk of hard default, the solution to this situation has direct impacts on the mitigation of other risks, including credit and macroeconomic instability risk.

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