

Cuban Integrated Financing Framework (CIFFRA)



REPORT N° 2 PESO CONVERTIBILITY CHALLENGES





In several exercises of the Joint Program “Support for the development of an Integrated National Financing Framework for the SDGs in Cuba” (CIFFRA), the inconvertibility of the Cuban peso (difficulty in accessing foreign currency in the domestic exchange markets) was recurrently identified as one of the main development financing bottlenecks in the country.

Accordingly, and as part of CIFFRA deliverables, a panel on “Currency Convertibility and Development Financing” was held on June 3, 2022, with the participation of more than 30 representatives from government, academia and the United Nations system, many of whom have participated in previous exercises and discussion forums of the project.

Presentations by Alberto Graña (former president of the Central Bank of Uruguay), Vilma Hidalgo (director of University Foundation for Innovation and Development) and Carlos Lage (ECLAC consultant) discussed in depth the international experience, domestic conditions and possible solutions to the inconvertibility of the Cuban peso.

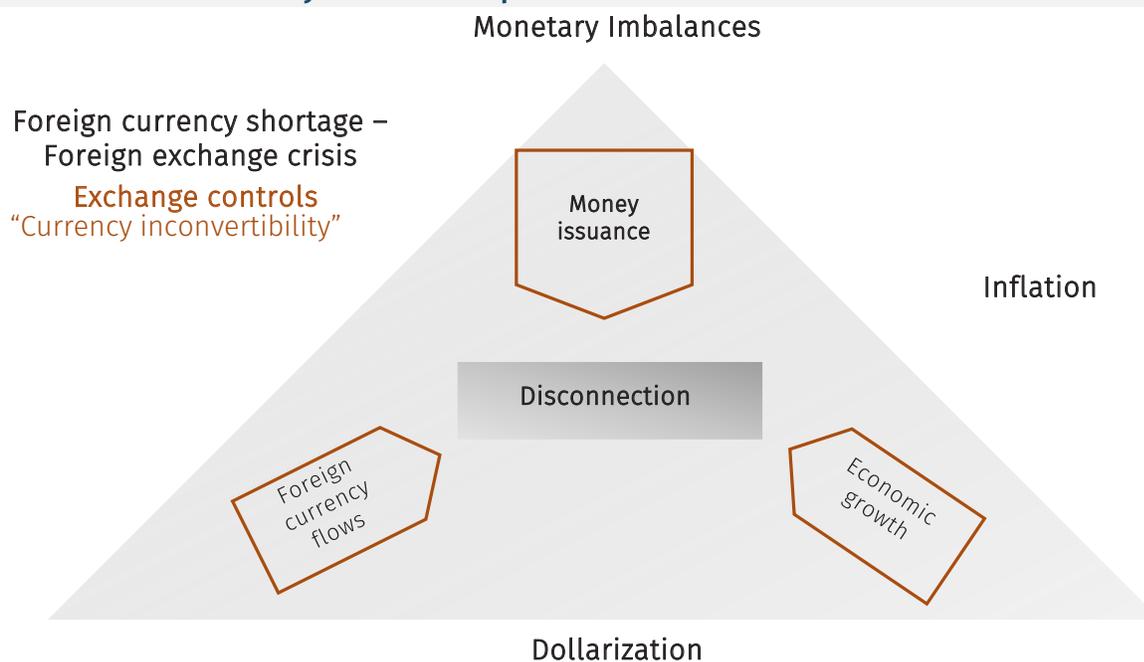
Alberto Graña addressed the issue from the international experience perspective, highlighting benefits and risks of current and internal account convertibility, prerequisites for internal convertibility and specific lessons from the Uruguayan experience. Graña emphasized key lessons from the regional experience, especially related to the requirements to achieve internal convertibility:

- ▶ Sustained fiscal deficits in an environment of restricted or stagnant supply are a direct channel of inflationary pressures, so fiscal discipline is the first requirement to ensure monetary and exchange rate discipline.
- ▶ A key objective of convertibility is the efficient performance of the payment system with domestic currency as the primary means of payment. This requires a sound macroeconomic environment, an appropriate choice of exchange rate regime, a monetary policy based on anchors or rules, and the development of domestic currency saving instruments.
- ▶ It is desirable to have a timeframe of the expected inflation trajectory. A macroeconomic program must include the authorities’ firm commitment to fight inflation, with the objective of preserving the real value for those who have fixed incomes in domestic currency and those who are committed to financing the State in domestic currency.

- ▶ In a convertibility scheme, the allocation of resources whereby relative prices does not really indicate the opportunity cost of resources among different alternatives will, in one way or another, have a direct impact on the current account.
- ▶ Convertibility, rather than an end in itself, is the corollary of the structural transformations leading to it. Therefore, it is a by-product of a process of transformations. History shows that building the foundations for a viable and stable convertibility scenario requires the broadest possible political support.
- ▶ Convertibility is not something that can be achieved in the short term. Accelerating processes of this nature may have an impact on important social variables that would ultimately affect the consistency and credibility of the program. Therefore, it is necessary to apply a gradual approach.
- ▶ Conflicts between monetary, fiscal and revenue policies or between the alternatives suggested by the different agencies involved, is quite natural. Therefore, it is necessary to establish formal coordination mechanisms (not leave solution to chance) such as hierarchies and arbitrators for dispute settlement and transparency and accountability mechanisms.

Vilma Hidalgo gave details about national currency inconvertibility problems in the last 30 years, as a manifestation of accumulated macroeconomic imbalances. She pointed out that in the Cuban context, inconvertibility expresses a disconnection between money issuance and GDP behavior, on the one hand, and between money issuance and the country's foreign currency flows, on the other (see Figure 1.) This disconnection is shown both at the macroeconomic and microeconomic levels, with underlying imbalances evidenced in (explicit and implicit) inflation and pressures on the balance of payments and the availability of foreign currency in the country.

Figure 1
Causes of the inconvertibility of the Cuban peso



Pattern of persistent loss of the currency's purchasing power: deterioration of its functions

Source: V. Hidalgo, *Inconvertibilidad del peso cubano. Evolución, causas y soluciones de mercado*, 2022.

Given the persistence of these macroeconomic imbalances over time, especially since the 1990s, there has been a process of partial dollarization of the economy that goes beyond a policy decision. It is a structural issue associated with a pattern of persistent loss of the currency's purchasing power, which has deteriorated the fulfillment of its functions over time.

In these circumstances, the policy reaction has been to restrict exchange between domestic currency and foreign currency in a very particular institutional context (exchange controls), in view of the risk of a destabilizing generalized devaluation or an exchange crisis due to a fixed exchange rate. This, however, has not prevented the impact of consequences similar to those under other alternatives.

The evolution of macroeconomic conditions in the last 30 years was characterized by: (i) vulnerability to external shocks, particularly the impact of the U.S. blockade; (ii) weak structural performance; (iii) explicit or implicit inflation; and (iv) conflict between growth and balance of payments resulting in external liquidity tensions. Most relevant among the internal factors that help explain the imbalances and inconvertibility are:

- i) Complexity of the institutional framework resulting from the monetary and exchange rate duality for more than two decades, which distorted relative prices (deficient incentive systems, particularly in the export sector) and undermined the response capacity of macroeconomic, sectoral and territorial policies.
- ii) Lax institutional arrangements that have not favored monetary and fiscal discipline. There is policy coordination and dialogue between institutions, but lack of monetary constraint on the actions of the fiscal authorities is evident (fiscal dominance).
- iii) Lack of an explicit commitment to an inflation target, so important to coordinate economic agents, especially in an environment of deregulation and decentralization such as that pursued with the updating of the economic model.
- iv) Oversizing of the administrative apparatus and the system of public enterprises, establishing restrictions for fiscal policy action. Policy efforts have failed to overcome productivity, competitiveness and efficiency gaps in the public enterprise system. Rather, the pattern of external dependence has deepened, which is also influenced by microeconomic elements (incomplete markets and market power).

Achieving macroeconomic stabilization and the recovery of the peso's convertibility is therefore a complex and urgent process that requires profound structural and institutional transformations, namely: (i) overcoming fiscal dominance; (ii) guaranteeing the sustainability of the balance of payments, ordering the foreign debt and intensifying attraction of FDI; (iii) accelerating the processes of structural transformation, betting on the prominence of the financial sector, the modernization of the public sector, new relations between State and companies, and productive modernization and reconversion; and (iv) consolidating institutional mechanisms for the implementation of reforms (planning, coordination, credibility, accountability).

Carlos Lage presented the main ideas of a proposal to redesign the exchange rate regime for the Cuban economy, drawn up by a group of experts from academia and the government. He initially addressed the complexity of the starting point: adverse macroeconomic environment, acute shortage of foreign exchange and limited room for authorities to maneuver. This implies that all alternatives involve policy sacrifices; which, nonetheless, are best taken on sooner than later.

Regarding the specific proposal, he warned that despite the negative experience with multiple exchange rates, they are still in place in the Cuban economy (the Monetary Overhaul failed to eliminate them) and

it is not possible to change them overnight. However, alternatives that initially bet on preserving multiple exchange rates (but managing them better), make sense if and only if there is a solid political commitment to move rapidly towards the unification of markets and exchange rates.

Accordingly, the proposal consists of a two-stage scheme to build a unified exchange rate regime. In the first stage, centralized and decentralized funds, multiple exchange rates, monetary duality, segmented exchange markets and strong exchange controls would coexist. However, controls would be managed differently, designing clear rules on who can have access to these markets and what exchange rate they face. At the same time, conditions will be created for the subsequent development and unification of exchange markets and exchange rates.

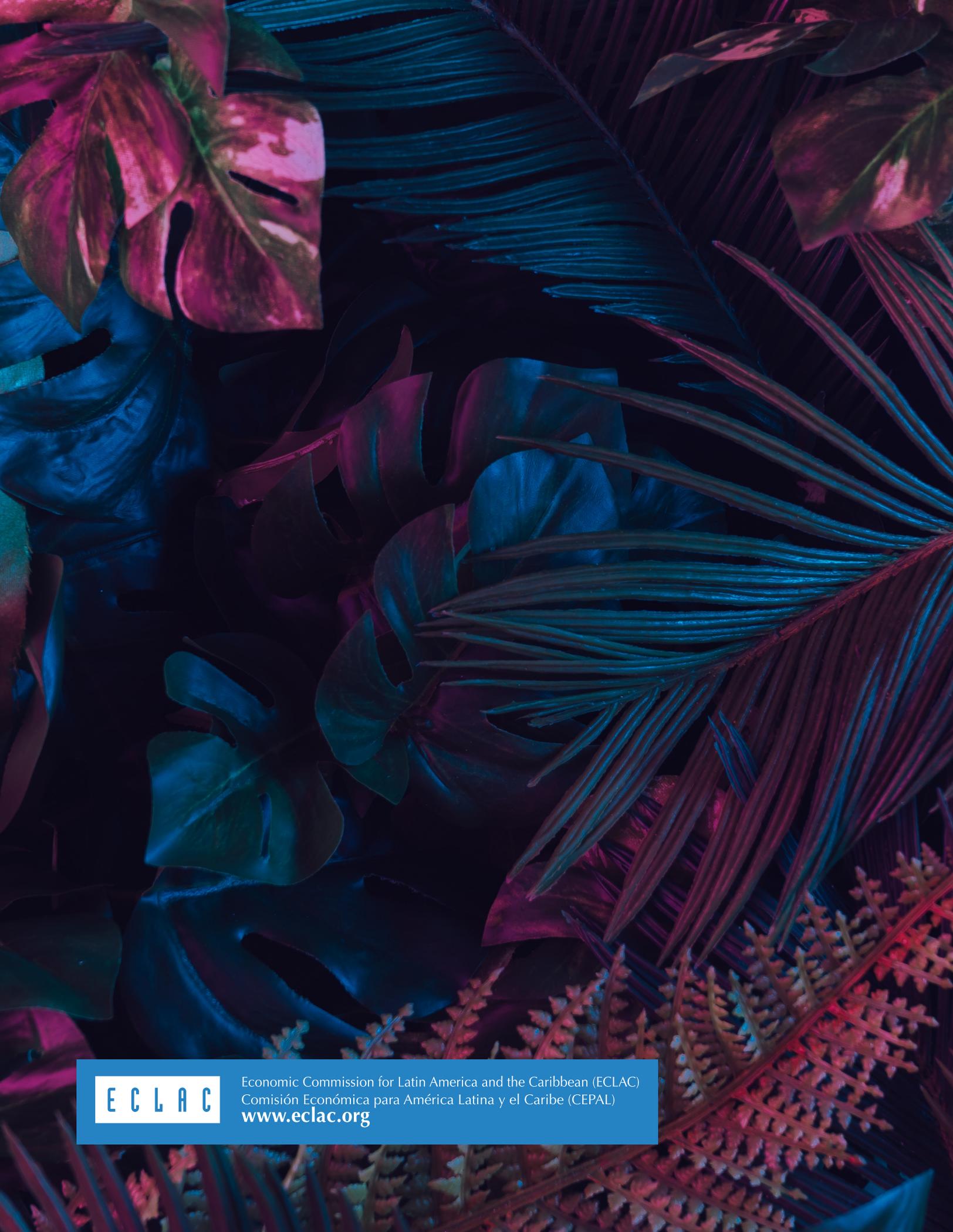
In the second stage, the strategic objective, a single exchange rate, would be achieved through a managed float exchange rate system, unified exchange markets and persistence of exchange controls, but with emphasis on the capital account.

He pointed out that moving towards an exchange rate regime guarantees institutionality, which is essential to accelerate the rest of the transformations but does not in itself guarantee the stabilization of the exchange rate. Therefore, its development must be accompanied (as a prerequisite) by a program of stabilization and productive transformation that acts on the fundamentals of economy.

The panel concluded with a wide discussion among the participants, highlighting the following messages:

- i) it is essential to consolidate macroeconomic coordination spaces in order to resolve the most pressing policy conflicts;
- ii) stabilization comes first, but can only be achieved through structural and institutional transformation;
- iii) there is a successful stabilization precedent in the 1990s that should be taken as a reference, taking into account the differences with the current context;
- iv) communication and popular participation is essential to ensure credibility and support for programs of this nature;
- v) some measures are particularly relevant within the stabilization program, such as the solution to the complex external debt situation; and
- v) there is no answer to all the questions, but there is consensus on the urgency of rebuilding the reputation of public policies, considering the short term, with clear results.

CIFFRA Technical Committee – July 28, 2022



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