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Monetary and Exchange Rate Reform in Cuba: Lessons from Vietnam

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Abbreviations and Acronyms

Cadeca: Official currency exchange agency

CPI: Consumer Price Index

CUC: Cuban convertible peso

CUP: Cuban peso

EIU: Economist Intelligence Unit

FDI: Foreign direct investment

GDP: Gross domestic product

Guidelines: Guidelines for Economic and Social Policy

HDI: Human Development Index

IFIs: International financial institutions

IMF: International Monetary Fund

ONE: Cuba's National Statistics Office

SOCBs: State-owned commercial banks

SOEs: State-owned enterprises

UNDP: United Nation Development Program

USD: American dollar

USSR: Union of Soviet Socialist Republics

VND: Vietnamese dong

Abstract

Since 2010, the Cuban economy has entered a new period of economic reform, officially labeled as an "update of the economic model." Cuba undertook a previous reform in the 1990s, but this was halted in the first decade of this century. Now, the new president, Raúl Castro, has insisted that the measures are permanent and structural.

This paper evaluates the three objectives of the proposed reform regarding monetary and exchange rate policy: 1) currency unification, 2) improving the monetary policy strategy and 3) financial transformations. In order to weigh the extent of the visible contents of the Cuban monetary and exchange rate reform and obtain lessons from international experiences, some elements of the Vietnamese reform are taken as points of comparison.

The starting point of the Cuban reform has many differences compared to Vietnam. The principal significance and benefit of looking at Vietnam lies in the similarities between the problems that Cuba is facing today in relation to those faced by Vietnam since 1986, when the country launched the Doi Moi reform, since both starting models share many characteristics of the Soviet-style system.

The state sector in Vietnam was smaller than in any other reforming socialist economy. Large-scale state enterprises formed only a small part of its economy. Dollar (1993), Perkings (1993) and Riedel and Comer (1995) conclude that the structure of the Vietnamese reform was convenient for responding to a "*big bang*" liberalization in the late 1980s. When small units are the majority, it is easier to make the market system work. Therefore, the Vietnamese economy was in a better position to respond to the incentives provided by market-oriented reform than is the current dominant big state sector in Cuba.

Early indications show that Cuban monetary and exchange rate reform will focus on the unification of the Cuban peso and convertible peso, the development of an interbank market, on the opening of personal credit and loans for non-state businesses, and the improvement of the strategy for the monetary policy through greater coordination and the establishment of rules.

Taking into account the Vietnamese path of reform, and the changes that would seem necessary to achieve the very goals of planned Cuban reform for 2011-2015, a group of lacunae could be identified, such as the issue of government bonds, the entrance of foreign

banks, greater competition and more flexibility in interest rates, as well as issues regarding transparency in the monetary policy.

Cuba's exchange rate adjustment in the 1990s was incomplete, since it took place only in the household sector. To eliminate the exchange rate and monetary duality, Cuban authorities must now extend the devaluation of the Cuban peso to the SOEs, joint venture companies and government institutions. They have to decide whether to do it gradually or by using a "*big bang*" approach, as in Vietnam. The large gap between exchange rates in Cuba (2,300%) speaks against a sudden devaluation of that magnitude, but also against the other extreme alternative of a too-slow adjustment that would require another twenty years of bearing the costs of monetary duality.

Low inflation is an important advantage of the current Cuban reform compared to the reform of the early 1990s, and also compared to Vietnam in the 1980s. However, the ongoing liberalization process could put price stability under risk. Like Vietnam, Cuba will experience inflationary pressures; first, coming from the unavoidable exchange rate devaluation, and second, because of the shift from officially-set prices to market prices. If Cuba's government is able to implement the planned labor adjustment and the fiscal restraints together with the opening to the non-state sector, then the risk of high inflation will be certainly lower.

A matter that arises from the overall analysis of the Cuban reform is the inefficiency of focusing the liberalization only on microenterprises and agriculture without taking advantage of the enormous amount of resources invested in education during the last five decades. It seems far better for sustainable economic growth, based on productivity gains, to extend the opening to the non-state sector on a larger scale, including a renewed aperture to foreign direct investments (FDI).

It is not intended that changes happen all at once, fracturing the macroeconomic and institutional stability of the country. In fact, as can be seen, the Vietnamese reform took several years to complete significant transformations of the economic system. However, Cuba should try everything possible to speed up its process in order to recover lost time.

1. Introduction

1.1 Macroeconomic Performance

The Cuban economy has stagnated since 2008, and is suffering a domestic financial crisis. In 2004-2007, gross domestic product grew at an average rate of 9%, while in 2008-2010 this dropped to 2.5%. The slowdown in the export of services and the absence of a new engine for economic growth essentially explain this dynamic. In the 1990s, tourism and nickel replaced the traditional role of the sugar industry as the main source of foreign exchange and the engine for economic growth. Since 2004, this role has been assumed by the export of professional services, mainly the export of medical services to Venezuela. In 2004-2007 the export of services grew at an annual rate above 28%. However, this slowed to just 3% in 2008-2010, and the previous trend is not likely to be regained.

Additionally, the economy had to deal with consecutive impacts of negative external shocks. The terms of trade fell 35% in 2008 and 15% in 2009. In 2008 there was a costly hurricane season and the country also began to feel the effects of the global crisis. All this caused a crisis in the balance of payments resulting in a domestic financial crisis. External debt payments were stopped, Cuban banks froze checking accounts and the Cuban convertible peso (CUC) lost its convertibility. The domestic financial crisis has had to be faced without the help of an international lender of last resort, as Cuba is not member of International Monetary Fund (IMF), World Bank or any other major international financial institution (IFI).[1]

The consequences of this complex macro-financial situation adds to the inefficiencies and distortions in the Cuban centralized state economy, which still has many similarities to the Soviet-style model despite the changes introduced in the 1990s. Among other factors, this model has shown, for over 20 years, its inability to achieve significant recovery of the Cuban family's living standards after the downfall of the European socialist countries.[2]

[1] Mesa-Lago and Vidal (2010) analyze Cuba´s macroeconomic situation in the 2000s, the impact of the global crisis, and the policy response.

[2] The average state salary, in real terms, dropped more than 85% in the period 1990-1993. Today´s real salary represents only 27% of the 1989 level. Its monthly purchasing power barely corresponds to 20 CUC (US$20). Families make ends meet with the help of state subsidies, remittances and incomes outside the state sector.

Table 1 summarizes the Cuban macroeconomic situation during the last 10 years: The brief economic boom in 2004-2007, the deterioration of macroeconomic indicators since 2008 (except inflation), and the following economic adjustment up to 2010.

Table 1. Cuba: Macroeconomic Indicators, 2001-2010

Indicator		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
GDP (constant prices)	*% of variation*	3.2	1.4	3.8	5.8	11.2	12.1	7.3	4.1	1.4	2.1
Exports (current prices)	*% of variation*	-2.9	-7.7	20.1	31.6	58.1	10.1	20.8	4.9	-10.7	12.9
Imports (current prices)	*% of variation*	-1.4	-13.2	10.4	19.3	44.6	24.6	6.0	43.3	-37.3	-3.3
Trade Balance	*Million of USD*	-916	-563	-245	280	1232	136	1712	-2484	2038	3930
Terms of Trade	*% of variation*	14.0	-7.9	15.2	9.9	-2.4	26.2	5.3	-34.6	-15.3	-3.2
External Debt	*Million of USD*	11,500	11,507	11,907	14,006	14,569	16,617	17,820	20,500	21,000	22,300
Fiscal Balance	*% of GDP*	-2.3	-3.0	-3.0	-3.7	-4.6	-3.2	-3.2	-6.7	-4.3	-3.6
Inflation	*% of variation*	-1.4	7.3	-3.8	2.9	3.7	5.7	2.8	-0.1	-0.1	1.4

Source: Author, on the basis of data from ONE (various years) and EIU (2010).

1.2 The New Economic Reform

On this scenario, it was confirmed in 2010 that the Cuban economy was entering a new economic reform, officially labeled as an “update of the economic model.” At the end of 2010, the “Guidelines for Economic and Social Policy” (Guidelines), was issued, a text that explains to some extent the content of the reform for the period 2011-2015.[3] The document was the subject of a public consultation and finally approved at the Sixth Congress of the Cuban Communist Party in mid-April 2011. President Raul Castro has specified that the goal of the reform is to “improve socialism.” In the 1990s, Cuba undertook a previous reform, which was halted in the 2000s once the country began to obtain income via its economic relations with Venezuela. On this occasion, the authorities have insisted that the measures are permanent and structural.[4]

[3] The document can be read in Spanish at the Granma website (2011).
[4] ECLAC (2010) describes the reform of the Cuban economy during the 1990s.

The new reform proposes the following actions as fundamental guidelines to be accomplished in the period 2011-2015:[5]

- Opening of a small-scale non-state sector: Self-employed (freelance), private microenterprises and cooperatives (besides in the agricultural sector, where they already exist).
- Cancellation of the full employment policy, which includes rationalization of state employment of more than one million workers in order to solve the problem of inflated payrolls in state-owned enterprises (SOEs) and government institutions.
- Restructuring the system of subsidies and taxes. Consideration of a phasing out of the ration card, and in general, the transition from a system of generalized (universal) subsidies to subsidies that are more selective and focused on lower income families. A new tax system is also to be constructed in line with the introduction of new economic actors beyond the state sector.
- Removal of prohibitions on the domestic consumer market, including the opening of a market for cars and houses.
- Moving towards greater decentralization, granting more autonomy to SOEs and local governments.
- Transformation of the agricultural sector, which has had land distribution in usufruct to private citizens and cooperatives as its main action.

The Guidelines have a section on monetary and exchange rate policy that outlines the intended changes for implementation in that field. These could be grouped into three directions or main goals: 1) currency unification between the Cuban peso and the convertible peso (CUC), 2) improving the monetary policy strategy, and 3) financial transformations. This paper attempts to evaluate these three objectives, with consideration for the current situation in the Cuban monetary and exchange rate policy after the transformations of the 1990s and the subsequent setbacks, while using Vietnam as point of comparison.[6]

[5] For a more detailed exploration of the current Cuban reform, see Alonso, Bayo and Gratius (2011).
[6] The Vietnamese reform has not been perfect but remarkable. Dollar (2002) summarizes as follows: "…*the story so far on Vietnam has been quite positive. There were large improvements in policies between the 1980s*

In order to weigh the extent of the visible contents of the Cuban monetary and exchange rate reform and obtain lessons from international experience, some stylized facts of the Vietnamese reform since 1986 (Doi Moi) are taken as points of comparison; experience to which the government itself has been referring to, but specific aspects are pinpointed without asserting that the Cuban Guidelines are following this model. As a matter of fact, reading the Guidelines and seeing the early measures of Raul Castro´s government, we cannot imply that the Cuban government is considering an immediate transit to the market socialism in the Vietnamese or Chinese style, and it is obviously not a transition process to capitalism as in the former socialist countries in Europe.

Moreover, the Guidelines do not provide sufficient detail on how to achieve the objectives; the analyses that can be made with the information available are quite general. Indeed, the Guidelines document is barely 32 pages in total. Frequently in this article, phrases equivalent to “The Guidelines do not mention ...” will be used. This does not mean that at some point the reform might consider certain options that at present do not appear explicitly in the public proposal regarding monetary and exchange rate reform.

The exchange rate and monetary policy will be enforced by the depth and extent of structural changes implemented in the overall reform. As in the 1990s, monetary and exchange rate policy strategy will have to readapt to the new economic scenario, but it would be better if design and preparation had begun in advance and with consideration for external experiences closer to the Cuban model.

The structure of the paper is as follows. Section 2 compares some general characteristics of the starting point of the reform in Cuba and Vietnam in order to aid comprehension of the overall framework. Section 3 examines inflation and its potential connections with the liberalization and adjustment process. In sections 4-6, the three previously mentioned objectives of the monetary and exchange rate reform are evaluated. In section 7 the first steps in monetary reform, taken by the Cuban authorities in December 2001, are commented on. Section 8 presents the concluding remarks.

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and the 1990s, an acceleration in growth, and a dramatic decline in poverty… However there are important areas in need of further reform.”

2. Vietnam as Point of Comparison

The starting point of the Cuban reform has many differences when compared to Vietnam, and some similarities. Table 2 is a very daring attempt to condense the main characteristics of the initial conditions for the reform.

Table 2. Cuba and Vietnam: Starting Point of Reform

Characteristic	Vietnam	Cuba
Population size	86.1 millions	11.2 millions
Demographics	Young and rural population	Ageing and urban population
Natural resources	0	x
Oil	0	x
Region	Asia (dynamic)	America (dynamic?)
US embargo	0	0
Soviet-style system	0	0
State sector size	smaller	big
Recent past of capitalism	0	x
Timing	0	x
Education	x	0
Health	x	0
Infrastructure	x	0
Overseas community	0	0

Note: "x" indicates absence or no significant presence compared to the other country. "0" indicates presence or relative abundance when compared to the other country.

Source: Author

The first rows show that three of the major differences are in size, demographics and natural-resource endowment. It is not efficient for Cuba to try to replicate a model of agricultural growth with a mainly urban and aging population, and after investing huge resources in education for decades. The urban population in Cuba represents more than 75% of the total; whereas in Vietnam it represented 18.8% in 1975 and 26.4% in 2005 (UNDP, 2008). The proportion of the population aged 65 and above is more than 12% of the total in Cuba, while in Vietnam it is much lower: 4.6% in 1986 and 6.3% in 2008 (World Bank, various years).

The transformations in Cuban agriculture are important at the beginning of the reform, since 40% of land is idle, and the dependency on food imports is between 60% and 80%.

This situation is deteriorating due to the international escalation of food prices.[7] There is also high popular dissatisfaction regarding food consumption. However, it is highly unlikely that Cuba can make the same response to the liberalization of the agricultural sector and the impact on economic growth as Vietnam did, mainly as a consequence of the dissimilar demographic conditions and because Cuban agricultural production accounts for only 4% of GDP while Vietnamese agricultural production accounted 40% of GDP in 1987.[8]

Vietnam had a windfall in the form of oil revenue at the time of the reform. International firms are drilling in Cuban waters in the Gulf of Mexico but there is no confirmed positive result so far. Cuba still depends on the import of oil from Venezuela. Another advantage for Vietnam has been its location in a more dynamic region. One similarity is that both countries were subject to the American embargo at the time of the reform; only in 1994 was the American embargo on Vietnam lifted.

Evidently, however, the principal significance and benefit of looking at Vietnam lies in the similarities between the problems that Cuba is facing today in relation to those faced by Vietnam since 1986, when the country launched the Doi Moi reform, since both starting models share many characteristics of the Soviet-style system. In addition, the two processes have attempted to focus on changes in the economic sphere, maintaining the essence of the political system and a willingness to undertake gradual reform, possibly stable, of the bureaucratic command model.[9]

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[7] An evaluation of Cuban agriculture can be found in Nova (2010).

[8] Chu Thi Trung Hau and Dickie (2006) summarize as follows: "*…spurred by land reforms and price liberalization, the agricultural sector in Vietnam not only helped ensure national food security, which had been a concern in the 1980s, but also contributed substantially to exports and rural incomes… In the 1990s, Viet Nam became the world's second largest rice exporter and one of the major exporters of several other agricultural commodities such as coffee and pepper.*"
They add that the share of agriculture in GDP has gradually fallen from from 33.9% in 1992 to 21.8% in 2004 (although it continues to utilize the majority of the labor force). During the same period of time, industry has been gaining increased importance in the economy with its GDP share rising from 27.3% to 40.2%.

[9] Most authors agreed that Vietnam combined a gradual reform with a "*big bang*" approach in some periods. Riedel and Comer (1995) note that: "*It is often suggested that the experience of Viet Nam, like that of China, demonstrates the superiority of the gradual approach to transition to a market economy over the 'big bang' approach followed in Eastern Europe and Russia. However… the pace of reform in Viet Nam from 1989 to 1991 was anything but gradual… The outcome was, nevertheless, very different from that in Eastern Europe and Russia, where 'big bang' describes the 'big collapse' in output that followed major reforms. Viet Nam escaped a 'big collapse' not as a result of differences in the relative pace of reform, but because there were fundamental differences in the structure of the economies of Viet Nam and those in Eastern Europe.*"

The most critical disadvantages that Cuban leaders have to overcome when compared to the Vietnamese are the large size of the state sector, the absence of recent experiences of capitalism, and that this is perhaps not the best timing for Cuban revolutionary leaders to transform the economy after several decades of avoiding recognition of the structural problems of the model and the necessity for dramatic shifts. One pessimistic view is that the current reform is too little, too late.

The state sector in Vietnam was smaller than in any other reforming socialist economies. Large-scale state enterprises formed only a small part of its economy. In Cuba, and also in Eastern Europe, the share of large-scale industries and state enterprises was far higher. Dollar (1993), Perkings (1993) and Riedel and Comer (1995) agree that the structure of the Vietnamese economy was convenient for responding to "*big bang*" liberalization. It is easier to make a market system work when small units are in the majority. Farmers, households business, and small industries can adjust their method of operation to market forces much more easily; they are natural net-income maximizers. They have less to learn when the overall economic system converts to market principles, while big industries need more time. Therefore, the Vietnamese economy was in a better position to respond to the incentives provided by the market-oriented reform than is the current dominant state sector in Cuba. In principle, this suggests that the reform should be more gradual in Cuba than it was in Vietnam.

In Cuba, the general government final expenditure accounted for 34.7% of GDP in 2008 whereas in Vietnam it accounted 7.8% in 1989 and 6.1% in 2008. With a big state sector, there is more room in Cuba for rent-seeking behavior and resistance from the bureaucratic sector. It is also more difficult to develop institutional transformations and change people's minds after fifty years of living under the same rules and ideology against the market and private sector.[10] On the contrary, Vietnam had a recent past of capitalism in the southern half of the country, and was therefore better prepared to adjust to market reforms. [11]

[10] Internal (and external) resistance against the Cuban reform is evaluated in Alonso, Bayo and Gratius (2011).

[11] Many entrepreneurs left Vietnam during the past two decades of Doi Moi, but an important base of entrepreneurial talent still remains. That is one of the reasons why the non-state sector developed so dynamically in response to the reform program. Additionally, economic links between overseas communities

Vietnam initiated its reform before the USSR collapsed; they even used Soviet aid to support part of the early costs and adjustments of the reform (Dollar, 1993 and Perkings, 1993). The Vietnamese GDP did not decrease after the collapse of the USSR thanks to the early reform, while the Cuban GDP dropped by 35% in the period 1990-1993. Cuba began a reform in the 1990s, but this was halted some years later. Real salaries in the Cuban state sector and the overall standard of living have never recovered completely following the demise of USSR. At present, most Cubans are skeptical about the capacity of their own government to achieve an efficient and productive economy and increase their standard of living. Raul Castro is eighty years old and there is no visible new generation of leaders. The current leaders are at a crossroads, since they want to implement gradual reform, but are running out of time. Obviously, this is not the best timing for the reform.

The major strengths of the starting point of the Cuban reform when compared to Vietnam appear to be the higher level of social development. Table 3 shows a sample of indicators on education, health and infrastructure.

Vietnam does not have bad indicators; in fact, in the Human Development Index classifies it within the countries with *medium human development*, ranking 105 with a positive trend for the index of 0.590 in 1985 to 0.733 in 2005. However, Cuba's social indicators are superior, as shown in Table 3. The country ranks 51, with a Human Development Index of 0.838, placing it among countries classified as having *high human development* (UNDP, 2008).[12]

It is also understandable that Cuba has better infrastructure than Vietnam at the inception of Doi Moi, given that Vietnam was just recovering from a painful and costly war. Even today Cuba has a number of better infrastructure indicators, as shown in Table 3. Nevertheless Vietnam has been investing in infrastructure with the help of FDI and foreign aid, and it is likely to surpass Cuba in some areas, such as telecommunications. Notice that in the last two rows of Table 3 how Cuba is behind Vietnam in the number of telephone lines and Internet users.

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and the home country sprang up rapidly, bringing managerial talent, capital and technology to the economy (Dollar, 1993).

[12]Mesa-Lago (2000 and 2005) and Espina (2008a and 2008b) examine the achievements and challenges of social policy in Cuba.

Table 3. Cuba and Vietnam: Social Indicators

	Vietnam		Cuba
	1989-1990	2005-2008	2005-2008
Education			
Public expenditure on education (% of GDP)	1.8	2.8	9.8
Adult literacy rate (% aged 15 and above)	87.6	92.8	99.8
Youth literacy rate (% aged 15-24)	93.7	93.9	100.0
Children reaching grade 5 (% of grade 1 cohort)	..	87.0	97.0
Combined gross enrolment ratio for primary, secondary and tertiary education (%)	..	63.9	87.6
Education index (within HDI)		0.815	0.952
Health			
Health expenditure, total (% of GDP)	..	7.2	11.5
Life expectancy at birth, total (years)	64.5	74.4	78.0
Mortality rate, infant (per 1,000 live births)	..	19.9	4.7
Maternal mortality ratio (per 100,000 live births)	..	56.0	46.5
Physicians (per 1,000 people)	0.4	1.2	66.3
Hospital beds (per 1,000 people)	3.3	2.9	4.6
Incidence of tuberculosis (per 100,000 people)	..	200.0	7.0
Infrastructure			
Population not using an improved water source (%)	42.0	15.0	9.0
Population without electricity (%)	..	13.2	0.5
Electricity consumption per capita (kilowatt-hours)	..	560	1,380
Telephone lines (per 100 people)	0.1	34.3	12.6
Internet user (per 1,000 people)	..	242	129

Source: Author, on the basis of data from ONE (various years), World Bank (various years) and UNDP (2008).

Finally, it is useful to note the fact that both countries have strong oversees communities. The Vietnamese government has promoted constructive links between overseas Vietnamese and the home country since the early stage of the reform. For Cuba this seems to be much more complex, but certainly not impossible.[13]

After recalling these general characteristics of both countries, the following sections explain what the Cuban government is planning for the monetary and exchange rate reform and gives a comparison to Vietnam’s efforts during Doi Moi.

[13]Domínguez et al. (2011) debate this option in a Cuban Catholic Church magazine.

3. Inflation, Liberalization and Adjustment

Before the partial reforms of the 1990s, the Cuban family's basic consumption basket was obtained almost entirely from state retail networks. In this environment, monetary disequilibrium was not reflected in prices, but in the accumulation of excess liquidity. Since the 1990s, the emergence of inflationary processes and exchange imbalances in the Cuban economy have become possible not only in the informal market, but also in the formal consumption markets and currency exchange agency (Cadeca), which was introduced during those years. This was reflected in the monetary policy strategy, which was increasingly less concerned with the appearance of phenomena such as excess liquidity and repressed inflation, and more for a final objective on price and exchange rate stability (Vidal, 2012b). This goal is now reinforced in the text of the Guidelines:

To conduct monetary policy to regulate the amount of money in circulation and credit levels, from the requirements of the plan and using the tools, in order to contribute to the monetary and exchange rate stability, as well as the orderly development of the economy.

After high inflation at the beginning of the 1990s, the economic authorities were able to stabilize prices. The variation of the consumer price index (CPI) in Cuban pesos has never been more than one digit since 1994. As already noted in Table 1, inflation remained low throughout the first decade of this century.

Regulated prices have a weight of 40% in the CPI in Cuban pesos. The remaining 60% are not prices directly controlled by the state, such as agricultural markets, self-employment and, curiously, the Cuban peso's CPI also shows a record of some informal market prices. The CPI of the convertible peso is not made public. However, besides specific periods of increase, an inflationary trend is not visible in markets in CUC.

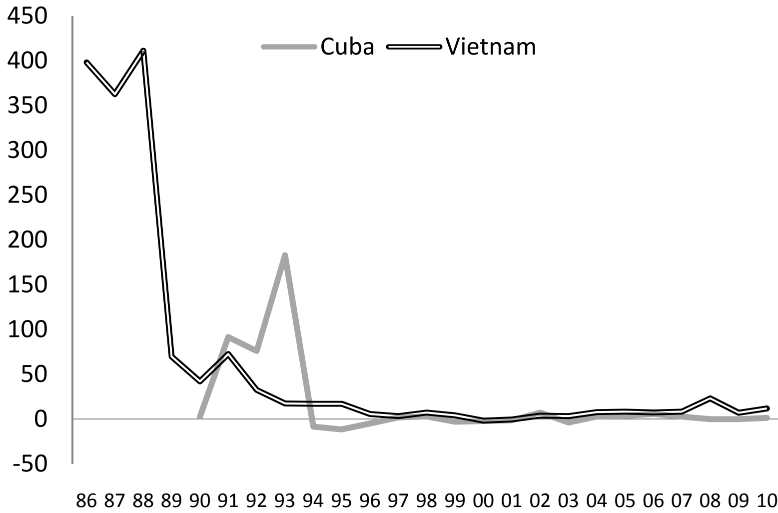
Low inflation since 1994 has some fundamental determinants in the Cuban economy. First, it has maintained an average low fiscal deficit (see again Table 1 for the most recent data). With no domestic market for public debt, the fiscal deficit is monetized by the Central Bank. Thus fiscal equilibrium immediately helps to regulate the growth of the money supply and hence inflation. Second is the policy of fixed exchange rates on both the Cuban peso and the convertible peso, and third is direct government control over state salaries and a part of the prices (Vidal, 2012b).

Low inflation is an important advantage of the current Cuban reform compared to the reform of the early 1990s, and also when compared to Vietnam (see Figure 1).

In Vietnam before 1986, the inflation rate fluctuated within the range of 50% to 90%. The liberalization process since 1986 led to higher inflation. Annual inflation rate rose above 350% in 1986-1988 (see Figure 1). The main sources of inflation were: i) the price shift from officially-set prices to market prices, ii) a larger fiscal deficit: When moving to a market system, subsidies to state enterprises increased while fiscal revenue fell since a new tax system requires a longer time for implementation, and iii) *pass-through* from the exchange rate devaluation to retail prices (Dollar, 1993, and Riedel and Comer, 1995).

Figure 1. Cuba and Vietnam: Inflation Rate, 1986-2010

(Annual percentage)



Source: Author, on the basis of data from ONE (various years) and World Bank (various years).

Vietnam has laid out a comprehensive disinflation program since the late 1980s (Dollar, 1993, Riedel and Comer, 1995 and Vo Tri Thanh et al., 2000). In 1989 the government started to bring prices under control (see Figure 1). The main stabilization measures were:

1) Real interest rate rise that provoked a strong portfolio adjustment by households in favor of banking accounts in dong and away from dollars and gold.

2) Fiscal restraints cutting subsidies to state enterprises, postponing investments, and demobilizing half a million soldiers. Since 1992 oil revenue and the inflow of FDI has also helped to reduce the fiscal deficit.

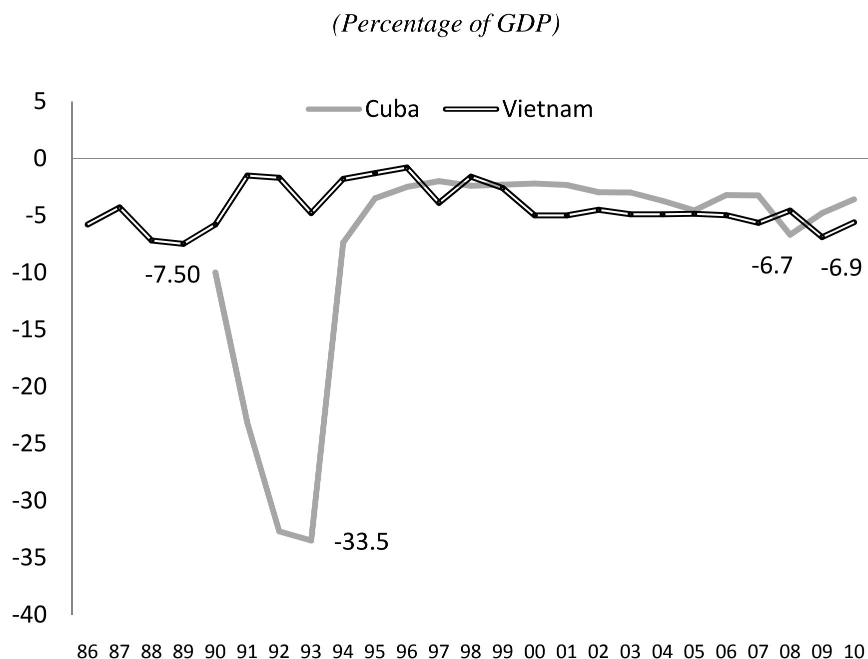
3) Labor adjustment in the state sector, first from 4.1 million in 1988 to 3.5 million in 1990 (600,000 in two years), and by 1992 up to 800,000 workers, who accounted for 33% of the state labor force. Most of this adjustment was in state-enterprise employment and less in the civil service. In this period the number of SOEs declined from 12,000 to 7,000. Unemployment was mainly absorbed by the household business sector.

Even though low inflation is an advantage of the current Cuban reform, the ongoing liberalization process could put price stability under risk. Like Vietnam, Cuba will have inflationary pressures resulting from the unavoidable exchange rate devaluation (see section 4). Inflation may also arise because of the price adjustment from the officially-set prices to market prices, the phasing out of the ration card, the changing of the system of subsidies, an increase in the non-state sector, the emerging of markets for houses and cars, and an expansion of bank credit for consumption and private business expansion, among other eventual market-oriented changes. Another potential source of inflation would be the very impact of some of those measures on the fiscal deficit.

The fiscal deficit in Vietnam during the Doi Moi reform was never close to the Cuban records of the early 1990s. The highest record in Vietnam was 7.5% of GDP in 1989, while Cuba surpassed 30% of GDP in 1992 and 1993. In the 2000s Cuba had an average fiscal deficit lower than Vietnam with a peak in 2008 (6.7%); the Vietnamese peak was 6.9% in 2009 (see Figure 2).

Figure 2.Cuba and Vietnam: Fiscal Deficit, 1986-2010

(Percentage of GDP)



Source: Author, on the basis of data from ONE (various years), Ministry of Finance of Vietnam (www.mof.gov.vn), Riedel and Comer (1995), and Chu Thi Trung Hau and Dickie (2006).

In favor of further price stability in Cuba, the strategy underlying the reform Guidelines appears to be to plan the fiscal and labor adjustment to occur before the macroeconomic imbalances emerge. The authorities are attempting to implement the adjustment of government expenses and taxes parallel to the liberalization of markets. The size of the state sector is being reduced, fiscal expenditures are dropping, and a new tax system is being put in place. The plan for 2011-2015 is to reduced employment in SOEs and government institutions by 1.3 million workers, which in absolute terms is similar to the Vietnamese labor adjustment and, in relative terms, accounts for 20% of the state labor force. The Cuban government also wishes to see the unemployment absorbed by the household business sector and agriculture, resembling Vietnam.

As shown in Figure 2 and Table 1 in section 1.1, the economic adjustment has allowed the Cuban authorities to reduce the fiscal deficit from 6.7% of GDP in 2008 to 4.3% in 2009 and 3.6% in 2010. An adjustment also took place in the area of foreign trade. In 2009, a severe import cut (-37.3%) was implemented, thereby allowing for the emergence of a

US$2,038 million surplus in the foreign trade balance of goods and services. The import reduction policy continued in 2010, albeit less severely; imports fell 3.3%.The last public data available reported 125,000 state workers laid off, while 180,000 new private self-employers and microenterprises registered during 2011.

If the Cuban government is able to implement the planed labor adjustment together with the opening of the non-state sector and the maintenance of fiscal equilibrium, then the risk of high inflation will certainly be lower. The question that arises is whether it is efficient to support new employment with the opening focused only on microenterprises and agriculture, without taking advantage of the enormous amount of resources invested on education. It would seem far better for sustainable economic growth based on productivity gains to extend the opening to a non-state sector of a larger scale, including a renewed aperture to foreign direct investment (FDI) beyond the small group of joint ventures that already reside on the island.[14]

[14] Chu Thi Trung Hau and Dickie (2006) remind us of some important facts regarding Vietnamese labor adjustment that can be useful for today´s Cuban reform. In Vietnam "*the number of household businesses increased from about 840,000 in 1990 to 2.2 million in 1996. This marked expansion of household businesses enabled the domestic private sector to absorb most employment growth including a number of workers laid off from the State sector. Households were however engaged mostly in agriculture, handicrafts and limited retail trade services. While the contribution of agriculture and the household sector to economic growth and poverty reduction in the initial years of Doi Moi was impressive, it was generally in the form of low productivity and low income employment and cannot be a major source of continued growth*."

4. Currency Unification

The dual currency in Cuba began as a process of dollarization in the 1990s, and was linked to the economic crisis, imbalances, high inflation and the resulting mistrust in the Cuban peso. Dollarization was only partial, the Cuban peso continued to be used in many areas of the economy, such as salaries, retail markets, savings accounts, and agriculture transactions, among others. After approximately ten years, in 2003 and 2004, a package of measures was implemented that led to the replacement of the dollar functions by a third currency, the convertible peso. Today the economy is no longer dollarized, but maintains the parallel circulation of two currencies, both domestic − the Cuban peso (CUP) and the convertible peso (CUC).[15]

During the 1990s, along with the dual currency system, a much more distorting factor was introduced; the dual exchange rate. The exchange rate of the Cuban peso in the informal market suffered a massive devaluation against the dollar in 1990-1993. This devaluation of the Cuban peso was later assumed by the state foreign exchange agency network (Cadeca) which carries out transactions only with the household sector. However, the devaluation was never taken into the accountability, financing or trade operations of the SOEs or joint venture companies. Even today, the exchange rate of the Cuban peso in the entrepreneurial system maintains the value it had during the 1980s.

The exchange rate duplicity of the Cuban peso is the main factor that has complicated the removal of the double currency system in the Cuban economy. For the household sector the exchange rate is 24CUP/CUC (through Cadeca), while for the business sector (SOEs, joint venture companies and also government institutions) the exchange rates is 1CUP/CUC.[16] Therefore, the main measure to be taken by the Central Bank for currency unification is the devaluation of the Cuban peso in the business sector.[17]

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[15] See Vidal (2012a) for more details on monetary duality in Cuba.

[16] The exchange rate for the convertible peso vs. the U.S. dollar is 1CUC/USD. The indirect exchange rates for the Cuba peso are therefore 24CUP/USD for the household sector and 1CUP/USD for the business sector. The Central Bank of Cuba has followed a fixed exchange rate policy for both domestic currencies, with exchange control in the business sector.
Companies and institutions are prohibited from going to the currency exchange agency (Cadeca) to arbiter exchange differences, which in itself is difficult since Cadeca deals only in small cash transactions.

[17] In addition, devaluation of the CUC against the USD (that is, to devalue the rate 1CUC/USD) will be helpful for exchange rate equilibrium and the promotion of exports.

The currency and exchange rate duality has huge costs for the entrepreneurial system. The excessively overvalued exchange rate of 1CUP/CUC (1CUP/USD) distorts economic measurement and decisions made at enterprises, at the fiscal level, and as part of central planning. The excessive value of the Cuban peso conceals subsidies as well as an artificially profitable group of companies on the one hand and a deceptively unprofitable group (especially exporters) on the other. The Guidelines talk of closing the steadily unprofitable SOEs, substituting imports and eliminating subsidies, but in reality, they cannot make sound decisions in this direction by measuring the costs using the 1CUP/CUC exchange rate. The overvaluation of the Cuban peso exchange rate has prevented its free convertibility for the business system, which discourages foreign investment, causes absurd segmentation, and constrains values chains, thus weakening the economy.

One might expect that the final objective of the elimination of the dual monetary system is the restoration of the Cuban peso as the sole monetary unit. The government's preference for the Cuban peso lies in several factors: i) it is the historical currency; ii) most of the Cuban saving accounts are in pesos, and the population has confidence in this currency that is reinforced by the popular expectation that once again the Cuban peso will be the only circulating currency;[18] iii) salaries are in pesos; paying the equivalent in convertible pesos would be further evidence of the low level of real wages in the state sector. This does not have an economic effect, but its political and psychological impacts are an effective toll on the people; iv) national accounts, the fiscal budget and key sectors such as agriculture operate in Cuban pesos.

Nevertheless, the Cuban reform Guidelines do not say that much, just this paragraph on dual currency:

It will move toward monetary unification in a process that depends mainly on increases in labor productivity, the effectiveness of distributive and redistributive mechanisms, and thus availability of goods and services. Due to its complexity, it will require careful preparation and execution, both on the objective and subjective level.

[18] In 2009 the savings accounts of the population in the Cuban SOCBs had the following composition: 59.2% in CUP, 37.6% in CUC and 3.1% in USD (Pérez 2011).

The paragraph on dual currency speaks about preparation on the subjective level since, popularly, the dual currency tends to be associated with the low purchasing power of wages and inequality. Cubans still regard the economy of the 1980s with the Cuban pesos as an ideal, and many of them expect to recover that status once all prices and incomes return to that currency. It is forgotten, however, that this status depended on Soviet subsidies and that it now requires a stern adjustment and revision of the model to boost productivity as the only way to increase wages.

The Guidelines are enigmatic on many further issues of exchange rate policy; the speed of the process of convergence in the exchange rates, whether the market will play a role in determining the equilibrium exchange rate or not, how convertibility for the Cuban peso will be opened in the business sector, and whether or not to continue the international trend to more flexible exchange rate regimes.

In the 1980s, Vietnam also had two official exchange rates that were excessively overvalued. In late 1987, the exchange rates were VND225/USD and VND368/USD, both far below the market level. The response of the Vietnamese authorities to this situation was sudden devaluation of the dong by more than 10 times. This is the so-called "*big bang*" approach applied to exchange rate reform. In 1989, Vietnam had a single exchange rate close to the market level (VND4,500/USD). Devaluation of the nominal exchange rate caused inflation, but a devaluation of the real exchange rate (Vo Tri Thanh et al, 2000).[19]

It is not possible to know for sure the path chosen by Cuba's economic authorities for currency unification. In the rationale of the still centrally-planned management of the economy, the authorities could choose gradualism in the form of a planned process of slow devaluation of the Cuban peso in the entrepreneurial system, with the possibility of differences between sectors and some other arrangements as a tonic to making changes in the margin. It would have to be decided whether to maintain controls on prices and manage the process of *pass-through* administratively, or allow it to undergo autonomous adjustment

[19] In the next two decades, after the devaluation and unification of the exchange rate in the 1980s, Vietnam implemented many modifications in the exchange rate regime. The State Bank of Vietnam has allowed more or less fluctuation in the exchange rate while retaining a dominant role in the foreign exchange market. The regime has been more managed than free-floating. This has resulted in an exchange rate that has remained sticky (Nguyen Tran Phuc and Nguyen Duc-Tho, 2009).

in wholesale and retail prices.[20] At the same time, it would have to take compensatory measures to mitigate the impact of devaluations in the currency-mismatched balance sheets of SOEs and SOCBs, at least for a reasonable period.

The large gap between exchange rates in Cuba (2,300%) speaks against a sudden devaluation of that magnitude, but also against the other extreme alternative of a too-slow adjustment that would require another twenty years of bearing the costs of monetary duality.

It seems that the exchange rate devaluation should be more gradual in Cuba than in Vietnam because the high proportion of medium and large SOEs in the economy makes it less prepared to respond to exchange rate incentives. As mentioned earlier, the state sector in Vietnam was smaller than in any other socialist country. Farmers, household businesses and small industries were in a better position to respond to a monetary reform and adjust their balances and operation to a new exchange rate.

Devaluation of the real exchange rate in Vietnam was very important for the export-led growth strategy. The devaluation of the real exchange rate had a positive impact on the balance of payments, but this was because it occurred together with an increasing flexibility in foreign trade, something that is not clear in the Cuba reform. Exports responded in Vietnam with a 25% annual growth rate in 1989-1993, but this was because it occurred together with the elimination of the state monopoly on trade, and access by exporters to imported capital goods and intermediate inputs (Dollar, 1993 and Riedel and Comer, 1995).

Another point is that Vietnam did not receive loans from the IMF or Word Bank to make its exchange rate adjustment (the American embargo was still in force at the time). Since they initiated the currency reform before the Soviet Union collapsed, they still had some aid from the USSR to compensate against negative effects of the exchange rate devaluation. Cuba is not a member of any major international financial institution and is undergoing a

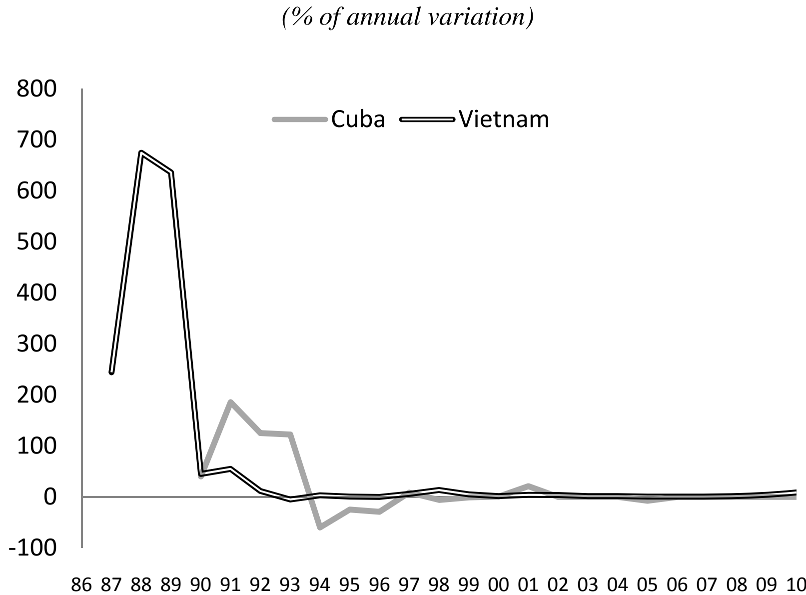
[20] Hernández (2011) estimates a response of 50% of the CPI in Cuban pesos to a shock of 100% in Cadeca´s exchange rate (household sector). However there is no such estimation for the *pass-through* for the official exchange rate of the Cuban peso in the business sector or in the markets in CUC, which is expected to be much higher as they are more connected to external trade.

domestic financial crisis. Therefore, it will have to implement the devaluation with scarce resources for compensation measures.[21]

In sum, Cuba´s exchange rate adjustment in the 1990s was smaller than that implemented by Vietnam during its monetary reform in the 1980s (see Figure 3) and it was incomplete since it only took place in the household sector. To eliminate the monetary duality, the Cuban authorities must extend the devaluation of the Cuban peso to the SOEs, joint venture companies and government institutions. They have to decide whether to do it gradually or using a "*big bang*" approach as in Vietnam or an intermediate strategy, if possible. Here, it is also important to combine the monetary adjustment with a more comprehensive liberalization process in order to better prepare the economy to respond to the exchange rate devaluation.

Figure 3. Cuba and Vietnam: Exchange Rate Evolution, 1987-2010

(% of annual variation)



Source: Author, on the basis of data from Cadeca and the World Bank (various years).

[21] Feinberg (2011) believes that it is possible for Cuba to become member of the International Financial Institutions (IFIs): IMF, World Bank and Inter-American Development Bank. He recommends a step-by-step approach taking into account legal and political constraints on U.S. policy, including restrictive Congressional mandates. He states that "…with their deep experience in countries seeking to improve the efficiency and competitiveness of their economies, and to transit to more decentralized modes of economic decision making, the IFIs are natural partners for Cuba today… IFIs have worked successfully in promoting poverty alleviation and economic growth in two of Cuba's closest allies, Vietnam and Nicaragua."

5. Improving the Monetary Policy Strategy

While since the 1990s the Central Bank of Cuba has wished to avoid high inflation records, it has not defined an explicit inflation target. Monetary policy has succeeded in keeping inflation low. However, the CPI data in Cuban pesos shows some degree of volatility, which in some cases alternates with deflationary records (see Table 1 in section 1.1). This is the result of a monetary policy with a discretionary approach, which tends to adjust past imbalances and is managed in an extremely difficult context of two currencies and multiple exchange rates. The following Guideline proposal should be understood in this sense:

To structure a proper approach to monetary planning in the short-, medium-, and long-term, we aim to achieve external and internal monetary equilibrium, not in a punctual way, but as a whole.

The paragraph also reflects the fact that the dual currency system and certain designs of the monetary policy have not facilitated the best way to articulate the internal balance and the objectives of external balance.

For example, coordination of policies for achieving internal balance and price stability has been favored by the GASFI (Analysis Group of Internal Finance), in which officials from the Ministry of Economy and Planning, Ministry of Finance and Prices, Ministry of Domestic Trade and the Central Bank, regularly gather in order to plan the actions that each of them can carry out to maintain monetary and fiscal balance. However, the same coordination and well-structured policy design approach to ensure consistency between internal and external balances does not exist.[22]

This lack of coordination between internal and external equilibrium did not help the management of monetary policy after dedollarization. The most obvious evidence is the currency crisis in late 2008. The CUC, the currency that replaced the U.S. dollar in 2003-2004, has suffered a convertibility crisis since 2008. Cuban banks were forced to freeze foreign payments from checking accounts in CUC due to the scarcity of foreign exchange reserves to maintain its convertibility.[23]

[22] For an analysis of GASFI and coordination in Cuban monetary policy, see Pérez (2011).
[23] Vidal and Gonzalez-Corso (2010) determined that the principal causes of the Cuban banking and currency crisis since 2008 have been: 1) the process of dedollarization initiated in 2003, which was implemented

After dedollarization, the *currency board*, which regulated the issuance of convertible pesos, was broken up. The emission of Cuban pesos is bounded by an institutional arrangement whereby the Central Bank cannot monetize a fiscal deficit above that approved by the National Assembly each year. However, there is no similar arrangement for the convertible peso. After the breakup of the *currency board*, monetary policy was freed to print unlimited CUCs. The absence of rules, among other factors, ended up producing an issuance excess of this currency.

Apparently, part of the reform is to correct this discretionary monetary policy design, as seen in the following paragraph of the Guidelines:

To establish appropriate rules for monetary emission and the use of indicators on time to allow its control.

Two absences in the text are the terms transparency and autonomy. It is very difficult to think of the success of a rule that is not transparent and cannot be publicly audited. Autonomy, at least instrumental, is essential for the implementation of monetary policy based on technical criteria, while at the same time establishing macroeconomic coordination as a way to harmonize the policies that determine the trend of the equilibrium in the medium and long term, including the plan in the case of a planned economy such as that of Cuba.

It is imperative to underline that in these areas Vietnam has not achieved the best progress. The institutional framework for Vietnamese monetary policy is based on an arrangement in which the National Assembly decides the annual inflation target and monetary policy strategy, and then monitors their implementation. In terms of objectives, Vietnam publicly defines its final annual inflation objective, as well as midterm targets for annual growth of M2, credit and dong devaluation, all consistent with the macroeconomic goals of the five-year plan. The nominal anchor rests mainly on the aim of the annually controlled dong devaluation, even when in recent years this has lost credibility. Despite all the shortcomings

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without the establishment of transparent rules to regulate the expansion of the convertible peso's monetary base, 2) the centralization of foreign exchange transactions in the *Unique State Hard Currency Income Account*, which contributed to the disproportionate concentration of financial risk in the hands of a single economic agent: the central government, 3) the deterioration of the country's macroeconomic indicators since 2008 and 4) the fixed exchange rate policy.

that the institutionality of the Vietnamese monetary policy has to be blamed for, it is much clearer and is designed with a greater degree of public information than the Cuban.

The other issue on monetary policy strategy mentioned by the Guidelines is the tools:

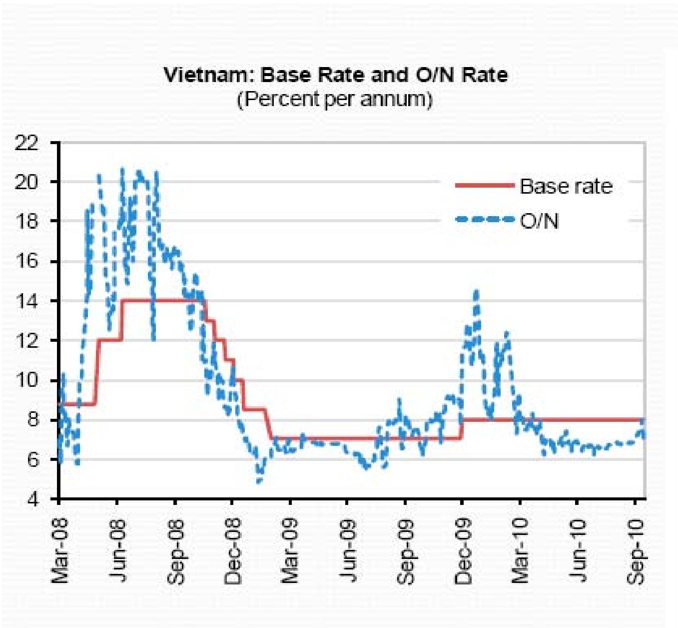
... to promote the use of monetary policy instruments—such as administrative control of credit, mandatory deposits from commercial banks at the central bank, the regulation of interest rates and lending to financial institutions—, in order to manage circumstantial monetary disequilibrium. In the sector of the population, the correlation between the growth of money and the retail trade, as well as the chance to manage this relationship in a planned medium term, will remain the key instrument for achieving monetary and exchange stability in this sector...

The quoted paragraphs emphasize the use of instruments of the direct control of interest rates and credit, in addition to the retail trade. The latter refers to the sale of retail goods and services in the state stores network, which is used to regulate demand in non-state markets and demand for foreign currency in the exchange agency Cadeca, and thus to influence price stability and the exchange equilibrium (see Pérez, 2011and Vidal, 2012b).

Comparing with Vietnam, it is evident that there has been a disengaging of direct instruments of monetary policy to focus on conventional indirect tools such as open market operations, legal reserve requirements and the discount rate. The State Bank of Vietnam has followed an international trend in guiding monetary policy actions through an interbank basic interest rate as an operational target (Figure 4) which exerts its influence through auctions of government bonds and using interest rates for deposits and loans of commercial banks with the central bank (Vo Tri Thanh et al, 2000).

In this regard, one final lesson obtained from Vietnam is that as the market economy evolves the role of direct or administrative control is reduced and the need for conventional monetary policy strategy increases. The experience of Vietnam, and even China, suggests that there is no special monetary policy strategy for socialist market economies; both have tended toward an international approach, albeit with more controls on the exchange rate and the financial system.

Figure 4.Vietnam: Interbank Interest Rate (overnight) and the Operational Target of Monetary Policy (base rate), 2008-2010



Source: Le Dang Doanh (2011)

6. Financial Transformations

In the 1990s, the Cuban financial system was subject to intense transformation. A two-tiered financial system was created that replaced the previous scheme of a single bank which works as central bank and at the same time has commercial functions, as was typical in socialist countries. In 1997 the Central Bank of Cuba was created as an umbrella organization for banking supervision, the payment system and was also responsible for monetary and exchange rate policy. To some degree, the banking system obtained independence from fiscal policy and in turn could be tempered to the new domestic and international stage after the demise of the socialist countries and Cuba´s partial opening to foreign investment, the tourist industry, remittances and some market spaces, among other changes in the reform of those years.

New commercial banks and nonbanking financial institutions were created, all state-owned but with a certain level of autonomy for client selection, risk management, and in general, with authority for credit decisions made within certain parameters defined by the Central Bank. Foreign private financial institutions, legally constituted, were allowed into the country, but only to open representative offices of their main headquarters. Within a limited legal framework, some of them have been offering credit and financial services related to joint ventures and also to SOEs.

Currently, the Cuban financial system is integrated by eight state-owned commercial banks (SOCBs), a bank with joint state capital from Cuba and Venezuela (Banco Industrial de Venezuela-Cuba), nine non-bank state financial institutions, and 15 representative offices of foreign financial institutions. The financial system achieved certain progress in upgrading, computerization and the development of new services and tools to capture savings and credit allocation.

The Central Bank has been fixing the interest rates on sight deposits and fixed term deposits for state banks, while defining narrow ranges for interest rates on loans. Implicit interest rates on other types of credit transactions, such as discounting bills of exchange and financial leasing, as well as loans from foreign institutions resident in the domestic economy in the form of office representation or located abroad have been further freed from regulation. Some competition between different financial institutions has appeared,

but within a very limited framework. The interbank market, one of the first issues addressed by the Guidelines, never achieved its peak, except for sparse interbank lending operations and deposits between financial institutions.

In this context of the direct control of interest rates, low competition and lack of an interbank market, monetary policy transmission mechanisms through the banking system have not been practicable (Vidal, 2012b). Decree Laws No.172 and 173 of 1997, which established the legal framework for the functioning of the Central Bank and the rest of the financial system, and which remain valid, left the door open to the use of the reserve requirements and the discount rate as instruments of monetary policy. In practice, however, they have never been used for such purposes.

On the other hand, the possibility of using open market operations has not been available because of the absence of a primary and secondary market for government debt. Nor are there any Central Bank bonds or other financial instrument that would serve to collateralize any operation of the expansion and contraction of the monetary base through the discount window. The absence of low-risk financial instruments, in turn, has restrained the development of an interbank market.

In this sense, a first proposal of the Guidelines is:

To develop an efficient interbank market that allows, among other things, to structure a more rational and meaningful system of interest rates and promotes the use of instruments of monetary policy.

A second transformation in the financial markets, as proposed in the Guidelines, is in the opening of credit to individual citizens. Financial institutions have developed their credit work primarily in the business sector, and only in a very controlled way in the household sector. Loans to individuals have been associated, at the most, with specific purposes within national programs regulated by the state. For example, sales of houses controlled by the state to individuals or the most recent replacement of more efficient appliances in a national program known as the Energy Revolution. These credits were never given directly in cash to a natural person; the funds were sent directly to the seller, in this case to a state enterprise, aiming to control use of the funds to the intended purpose.

In 1998 the Central Bank of Cuba issued Resolution No.97, in which it is accepted that a citizen can go to the banks to borrow for their own purposes, and that the loan is provided in cash to the applicant. This was implemented for some years, but later canceled.

The third and last point is that the financial transformation that appears in the Guidelines is intended to prepare the banking credit and services for non-state forms of production. The text quotation is as follows:

To provide the necessary banking services, including lending, to the non-state economic sector to contribute to its proper functioning.

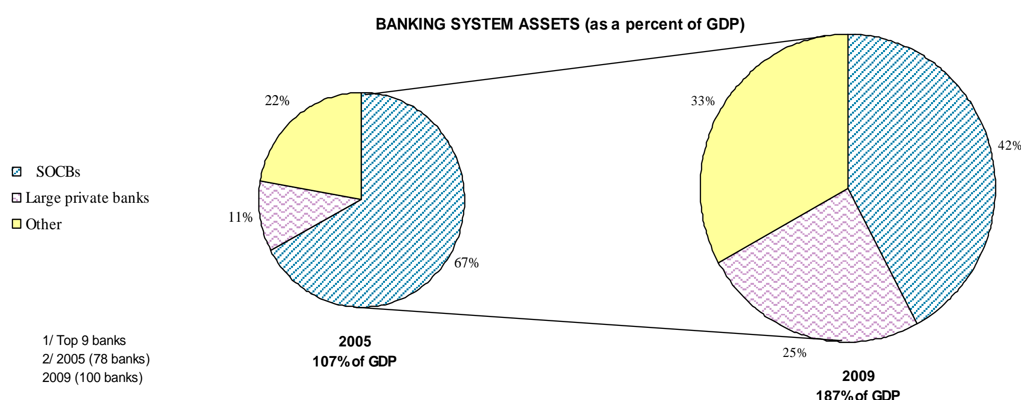
These are the reforms mentioned by the Guidelines that are planned to take place in the financial system during the period 2011-2015. As stated, the document is declarative, allowing us to see only some general goals. Still, attention is called to certain absences in the text suggesting the limits of this financial reform. The first impression is that, from the monetary and financial viewpoint, economic reform now seems much less embracive and intense than that carried out in Vietnam.

To make a comparison with Vietnam, some of the most important financial changes that occurred during the reform process are summarized below:

1. Since the 1990s, a two-tiered financial system has been established.
2. During the 1990s, new banks were created and the types of financial institutions diversified. Modernization and computerization of the banking process was initiated.
3. Entry of foreign banks and diversification of ownership of commercial banks led by the process of selling shares gradually occurred (equitisation).
4. In 1993, Vietnam joined the IMF, the World Bank and the Asian Development Bank.
5. In 1995, Vietnam began to liberalize interest rates (completed in 2002).
6. In 1995, government bonds were issued and the development of auctions was begun.
7. In 2000, open market operations to control the monetary base and the interbank interest rate were used for the first time.
8. The reform continues. A new law for the State Bank of Vietnam has been passed.

The Vietnamese banking system is currently formed by four major SOCBs, 37 join-stock banks, 37 foreign bank branches, six joint venture banks and two development banks. SOCBs hold 42% of the banking sector assets, but with a downward trend. For instance, in 2005, SOCBs held 67% of overall assets and in 2009 this was reduced to 42% (see Figure 5). At present, foreign banks control 12% of the credit market. In spite of the significant transformation and development, some weaknesses persist in the Vietnamese banking system. There is a high level of non-performing loans, a credit system biased toward SOEs, and fragilities in the banking supervision and informal finances, especially in rural areas (Dollar, 2002 and Suiwah Leung, 2009).[24]

Figure 5.Vietnam: Banking System Ownership, 2005 and 2009



Source: Le Dang Doanh (2011)

Cuban financial reforms during the 1990s reached point 2. of the abovementioned Vietnamese path, and then stopped. The visible contents of the current reform, do not suggest that it is intended to continue to any of the other points. Disregarding some of these points, however, could make it more difficult to achieve the very goals proposed by the Guidelines.

[24] Dollar (2002) stated that: "*Vietnam made an initial set of reforms in the financial sector, but the banking sector is still dominated by a few, poorly managed state banks. Much of the outstanding credit of these institutions is to state-owned enterprises. Some of the SOEs, especially those working with foreign partners, are doing well, but many are in financial difficulty. Hence, the financial sector is saddled with a large degree of non-performing loans. This results in high spreads and poor ability to channel funds to the most productive investments… it also represents a contingent liability that weakens the government's fiscal position.*"

For instance, the development of an interbank market requires liquidity and low-risk financial instruments for the collateralization of overnight and short-term loans. The issuance of government bonds would help in this regard, and would also contemplate a future for open market operations and the increase of the use of monetary policy instruments. It will also be necessary to promote the fledgling competition that emerged in the 1990s, as well as greater flexibility in interest rates.

The development of an interbank market would be more expeditious if the creation of joint venture banks with foreign capital is promoted. Right now, the Cuban banking system is going through a liquidity crisis. Foreign banks would aid the entry of capital and financial technology to support the interbank market and, particularly, the other two aspects the Guidelines refer to; credit to the non-state sector and personal loans.

Many foreign banks would not dare to enter the Cuban market because of restrictions imposed by the U.S. embargo, but where there is a possibility, Cuba should evaluate it pragmatically. Some mixed-owned banks with state and foreign capital may sprout out of the representative offices of foreign institutions now resident in the economy. This will also help to outwit the U.S. financial embargo.

7. Cuba´s First Step in the New Monetary Reform

The Cuban government made its first step toward monetary transformation in December 2011. Since that date, the self-employed, micro businesses and private farmers are able to access formal credit and banking services. The new financial regulations apply equally to the forthcoming non-agricultural cooperatives and other non-state entities that may be allowed in the future. This new legal framework puts them practically on an equal footing with the financial services and credit that SOEs can access. The regulations also leave the door open to loans for consumer goods, automobiles and home purchases, even though they state that this will not be a priority for the time being (Ministerio de Justicia, 2011).

Three SOCBs (Banco Metropolitano, Banco de Crédito y Comercio, and Banco Popular de Ahorro) are in charge of providing the new loans and financial services. The self-employed and micro entrepreneurs may apply for loans starting at 3,000 CUP, US$125 at current exchange rates, while loans for private farmers start at 500 CUP, or US$21. These loans can be used both for working capital or investment purposes. There is no upper limit on the loan amounts. The Central Bank sets minimum and maximum interest rate ranges.

Until now, capital for private businesses has originated from the savings of the entrepreneurs, remittances from abroad, and informal finance. The opening of credit by state banks allows the addition of new resources at the disposition of private undertakings. In principle, the banks would be better qualified to select projects with higher profitability and lower risk, which in turn would increase efficiency in the allocation of temporarily free resources in the economy. This would avoid a proliferation of informal finance.

A foreseeable challenge is whether, effectively, these three banks — whose basic experience and knowledge was formed under the logic of credit for medium-size and large SOEs — will be able to speedily assume the principles that govern microfinance. An alternative, more attuned with international practices (even in Vietnam), would have been to create microcredit banks or other financial institutions that solely specialize in serving this market segment. The formation of mixed-capital microcredit institutions would multiply the financial, logistical and know-how potential of Cuban banks facing the opening of a non-state small-business sector.

The other new financial measure is that banks may open checking accounts in Cuban pesos or convertible pesos for non-state sector clients. The opening of a checking account is obligatory for businesses with gross annual revenues exceeding 50,000 CUP (US$2,083). The entire non-state sector may use, in addition to cash, the following payment instruments: a) bank transfers, b) checks, c) payment orders, d) debit or credit cards, e) local letters of credit, f) demand bills, g) promissory notes, and h) others that are used in banking.

The new financial services represent challenges for the Cuban banks, which seem to have already reached capacity in serving their existing clientele. That clientele, moreover, has little access to alternatives such as online or telephone banking, magnetic cards and automatic teller machines (despite the progress made in computerization in the 1990s)., Bottlenecks in providing financial services to the private sector are therefore likely to be experienced.

The possibility of non-state businesses opening checking accounts and using all payment instruments has the following positive effects:

• Their operational costs will shrink. They would be able to pay their taxes, social security contributions, utility bills, and more through banks. This would reduce the risk and cost of handling and accumulating excessive amounts of cash.

• Their links with SOEs would begin to be financially viable.

• Legal control would be facilitated; this would particularly contribute to reducing fiscal evasion.

For monetary policy, the opening of banking and credit for the non-state sector has implications. It can bring about considerable changes in the composition of demand for money and in the measures among the monetary aggregates that are relevant to the control of inflation. Once credit expands to private business and consumption, new monetary transmission mechanisms will appear, and this will increase the capability for monetary policy action to influence economic activity in the short term, and to control inflation.

8. Conclusion

Early indications show that Cuban monetary and exchange rate reform will focus on the unification of currencies, the development of an interbank market, the opening of personal credit and loans for the non-state sector, and the improvement of the strategy for monetary policy management through greater coordination and the establishment of rules. The first step in the monetary reform, which took place in December 2011 – credit and banking services for the new private sector – seems very positive because it amplifies the role of banks, credit and monetary policy and also because it signals the real acceptance of new actors within the Cuban economic model.

Taking into account the Vietnamese reform, and the changes that would seem necessary to achieve the very goals of the Guidelines, a group of absences in monetary and exchange rate reform could be identified, such as the emission of government bonds, the entrance of foreign banks, greater competition and more flexibility in interest rates, as well as issues related to the transparency of monetary policy. It seems that there is no special monetary and exchange rate policy for socialist markets economies. Therefore, the sooner the Cuban Central Bank starts developing the conditions for conventional monetary and exchange rate strategy the better.

Devaluation of the exchange rate for SOEs, joint venture companies and government institutions is unavoidable. It should be done more gradually than in Vietnam, because the high share of medium and large SOEs in the Cuban economy makes it less prepared to respond to exchange rate incentives. Devaluation of exchange rates, fiscal restraints, labor adjustment and liberalization are pieces that would fit together if a suitable balance and proper time orchestration is achieved; otherwise, high inflation will rebound in the Cuban economy. Liberalization should not only focus on agriculture and microenterprises, but extend the opening to a non-state sector of a larger scale and FDI in order to boost productivity and take advantages of the high level of social development, especially education.

Monetary and exchange rate reform combined with a more comprehensive liberalization process will facilitate the finding of new engines for export and economic growth and overcome the domestic financial crisis. It is not intended that the changes occur all at once,

overlooking the particular initial conditions of the country and, as a consequence, fracturing macroeconomic and institutional stability. As can be seen from Vietnam, even applying a "*big bang*" approach in some periods, the reform took several years to complete significant transformations of the economic system. Yet Cuba should try everything possible to speed up its process to recover lost time.

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List of Major Works

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