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CUBA'S LIMITED ABSORPTIVE CAPACITY WILL SLOW NORMALIZATION *Fulton Armstrong**

As the U.S. embargo—the main obstacle to expanding U.S.-Cuban economic ties—is relaxed by presidential regulatory action and eventually lifted by Congress, limits on Cuba's own willingness and ability to conduct trade, absorb investment, utilize information technology, and even accommodate tourists risk putting a brake on the normalization of economic relations. Five decades of embargo and failed socialist models have rendered key sectors in Cuba ill-equipped to take advantage of the surge in U.S. business interest in the island. In some areas, the political will to open up and reform is crucial. These problems do not translate into a rejection of normalization but rather into a slower timeline than many on and off the island would hope for.

After 50-plus years of estrangement, bilateral contacts since last December have given rise to high levels of optimism—among U.S. investors, importers, and exporters—about relatively rapid economic engagement. Press reports and information from Cuban and non-Cuban experts suggest that most Cubans, skeptical that their government will make reforms facilitating trade and investment quickly enough, are slightly more pessimistic. But hardly a week goes by that U.S. trade experts, think tanks, and media don't reflect strong private-sector interest in Cuba. Visiting Havana in October, U.S. Commerce Secretary Penny Pritzker emphasized, "What we're trying to do is be as open as we can until the blockade [sic] is lifted."

Cuba has not been shy about its desires either. Secretary Pritzker said Cuban officials "have been very forward leaning and wanting more American direct investment." Last year, the Cuban government announced its "Portfolio of Foreign Investment Opportunities"—some 246 projects in energy, tourism, agriculture, and industry—for which it seeks US\$8.7 billion in investment. Moreover, Havana says it wants growth rates to rise to 4–5 percent per year (from an estimated 1.5 percent in 2014), fueled by at least US\$2 billion in annual foreign investment.

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BIG OPPORTUNITIES ...

Tourism is an experienced, growing industry that—at 3 million visitors per year—could become an even more powerful producer of the hard currency that Cuba needs. It is already seriously challenged to accommodate growth, however. Major hotels are over-capacity (while some others, because of under-investment and poor management, have rooms lying idle). Anecdotes of poor service, inadequate facilities, and high prices continue. If the U.S. Congress changed the law to allow tourist travel to Cuba, the industry would be easily overwhelmed. But its potential for growth and profitability is enormous.

U.S. **trade and investment** are potentially powerful engines for growth and employment in Cuba. Visits by Secretary Pritzker (October), U.S. Chamber of Commerce President Tom Donahue (May), trade delegations from New York State (April), Arkansas (September), and other states, and hundreds of U.S. importers, exporters, and investors underscore the eagerness of the U.S. private sector to sit down with Cuban partners. The Cubans' billion-dollar expansion of the deepwater port in Mariel and construction of a “special economic development zone” there—allowing up to 100 percent foreign ownership and generous tax benefits—reflects their interest as well.

Cuba's small private sector, currently employing over a million people, could drive a significant increase in bilateral economic activity. Obama's January 2015 regulatory changes licensing an exception to the embargo for U.S. trade with Cuba private business puts the *cuentapropistas* in the awkward position of being the persons with whom the United States can conduct most trade. Lacking legal, reliable wholesale sources for essential supplies in Cuba, these small entrepreneurs have demonstrated creativity and persistence in securing inputs elsewhere—often carrying goods back from abroad in suitcases. With a more supportive infrastructure, they could provide many more vital goods, services and employment that the Cuban government years ago admitted it could not provide.

The **agricultural sector**, in which private production has long dominated, could readily drive trade and growth. Private farmers have long out-produced their state competitors and many cooperatives, making them ideal for engagement under current U.S. regulations if the Cuban government facilitates it. Citrus and other fruits could expand quickly. For a country that

spends over \$2 billion annually to import 70 percent of its food, higher agricultural productivity is a matter of both economic necessity and food security.

Sectors utilizing Cuba's specialized and skilled human capital, such as **biotechnology**, could also benefit quickly and generously from the new U.S. relationship. With a little effort, Cuba could also build the capacity to snatch lucrative **call-center and other support services** away from Costa Rica and other Latin American countries.

... BUT LIMITED CAPACITY

Cuba has a lot going for it but also glaring capacity shortfalls. Even optimists among U.S. companies interested in dealing with Cuba are concluding that the country's ability to increase trade, absorb investment, and take advantage of other opportunities is limited—and will take several years to catch up. Indeed, Cuba's absorptive capacity is mixed—with clear strategic strengths and weaknesses.

The educational level and good health of the Cuban people represent an important asset—a deep reserve of **potential human capital**—that could develop rapidly as the country opens up. The quality of schools and teachers has suffered during the country's prolonged economic crisis, but its claims of nearly 100 percent literacy and 86 percent high school attendance are generally respected. Cuba has solid universities with strong technical programs. Graduates of the country's universities may not be competitive in all technical areas with counterparts in some Latin American countries, but the ethic of education runs deep.

- Cubans' ability, moreover, to *resolver* and *inventar* is evidenced by more than just anecdotes about keeping old cars on the road and putting meals on the table during lean times. Even in energy (quadrupling oil production from questionable wells), renewable clean power, and biotechnology, Cubans have excelled at doing more with less. Although Cubans are poor on paper (typically earning the equivalent of US\$22 a month), generally accepted estimates of their per-capita GDP, based on purchasing-power parity, are about \$10,000 a year.

But Cuba's potential is held back by a variety of factors, including **political caution**. Although some of the decisions they face are indeed tough, Cuban leaders' perennial concern

with control—exacerbated by the fact that change entails shifting powers and new risks—is undoubtedly a hindrance to the country’s ability to adapt to changing circumstances. A penchant for suspicion and control has plagued Cuba’s economic relations with investors for years, and this will only be magnified with prospective partners based in the United States.

- Cuba is updating laws governing investments, property, and labor, but the multi-year process and incremental nature of the reforms has been too slow to keep ahead of burgeoning opportunities. Cuban laws and regulations change too little, too slow.
- In March 2014, Cuba approved a new foreign investment law exempting foreign firms from paying taxes for the first eight years of operation and reducing other taxes. It also established expedited procedures for approving investments and making the application process more transparent. Nevertheless, most observers say the laws protecting trade and investment are still inadequate. Another area requiring clarification is how firms select, pay, and release Cuban employees. The director of the Mariel zone announced last year that, in effect, Cuban workers there will be allowed to receive a higher percentage of their wages—about one quarter—from their foreign bosses, but the state employment agency and government will still keep 75 percent of it. Workers in other areas of foreign investment get an even worse deal—about 10 percent.

Unifying Cuba’s two **national currencies** is absolutely essential but, despite the government’s repeated declarations of intent, it has still not been done. The Cuban peso (CUP) and the convertible peso (CUC) trade at a rather stable rate of about 24 to one, but the existence of a different, lower exchange rate for state enterprises creates distortions that will worsen as demand for imports rises. Most economists argue that the government should do the hard work of unifying them into one market-based currency before demand rises. Deft macroeconomic policies can help Havana mitigate, but not avoid entirely, the sort of crisis that other economies in transition have faced.

The **process for approving foreign direct investment** has been streamlined some, but the paperwork remains formidable and must pass through multiple levels—the bigger the project, the higher up it must go. Investors complain that approvals take a long time and depend on applicants’ ability to make personal appeals to one or two senior officials in a non-transparent

process. The potential for a big increase in FDI will not be realized unless approvals are handled in a more timely fashion.

The country also lacks the basic government or private institutions necessary to **license import and export transactions** for beneficiaries outside government ministries, to coordinate the movement of raw materials and finished products in and out of the country. The ministries conduct trade on behalf of state enterprises, not private individuals. Neither has the government allowed the creation of enterprises (state or private) to organize imports and exports on behalf of *cuentapropistas*, nor the creation of effective wholesale mechanisms responsive to them.

Similarly, the **financial system** is too over-burdened, secretive, and lacking in agility, and continued blocks to Cuba's access to IMF, World Bank, and Inter-American Development Bank (IDB) funds deny it important breathing room to reform. The Cuban Central Bank does not publish the country's net international reserves, and estimates vary wildly. Cuban authorities claimed last year that the country had US\$10 billion in reserves, but a more sober analysis, based on other countries' reports to the Bank for International Settlements, suggests that its assets at the end of 2014 were only \$1.3 billion (with deposits in Chinese and Venezuelan banks probably accounting for a fraction more)—a cushion equivalent to only two months of imports.

- Havana has negotiated a write-off of much of the \$25 billion it owed the former Soviet Union, but its “Paris Club” debt, which has limited its access to international finance since a 1986 default, amounts to some US\$15 billion (including principal, interest, and penalties). The Economist Intelligence Unit estimates that negotiations with its 19 Paris Club creditors should conclude within the next year and a half—reopening some access to credit with those countries but not the United States.
- Domestically, there are hints of change in the air. The *Banco Popular de Ahorro* in September announced it would open lines of credit to small private businesses—up to 10,000 pesos (US\$400)—with minimal paperwork, and authorized its municipal offices to make similar loans without seeking higher authorization. (Observers tend to agree that these measures are a politically significant step in the right direction, but Havana has so far refused offers by Brazil and others of microfinance loans for private entrepreneurs.) The real test will be the financial sector's ability to balance needs between much more powerful sectors, including struggling and failing state enterprises.

- Membership in the multilateral banks would obviously help Cuba reform its financial sector. IMF balance-of-payments support would help. World Bank programs could be easily directed at important infrastructural projects. U.S. law still requires, however, that Washington oppose Havana's participation in both "until the President submits a determination . . . that a democratically elected government in Cuba is in power."

Cuba lacks an **Information and communications technology (ICT)** framework capable of harnessing and nurturing its human capital and propelling it into a more lucrative future. Landline and mobile phone subscriptions are increasing—to 11 and 23 per 100 inhabitants, respectively—but reliable rankings place Cuba 125th and 209th in those categories (out of 213 countries). Despite some progress expanding internet access, with about a quarter of citizens getting online at least occasionally and at least on Cuba's closed national network, the network is by most accounts too primitive, slow, and expensive to be an effective driver of development. Cuba has contracted with Chinese companies, which built its fiber optic backbone network in the early 2000s and played a major role in the construction of the "ALBA-1" undersea cable with Venezuela in 2011, to install and maintain internet links around the island. But such projects will probably take years to improve Cuba's ICT capabilities. Slow ICT development will retard progress in a number of priority areas.

The **dilapidated infrastructure** presents opportunities to investors eager to rebuild it—with a total price tag estimated as high as US\$30 billion—but it is a major disincentive to industries that would rely on it. The **transportation sector** is in dire need of repair and modernization. According to one uncorroborated estimate developed in 2011, the cost of preparing highways and railroads for economic development will be more than US\$20 billion. The **construction industry** is also inefficient and poorly resourced.

- The special zone in Mariel is based on a widely recognized model and is likely to succeed, but it has attracted only eight companies since opening 18 months ago. Moreover, there are useful precedents for Cuba to enter into *empresas mixtas* with foreign firms on infrastructural projects. The Havana water company, *Aguas de la Habana*, as long ago as 2000 signed a 25-year management contract with the Spanish firm *Aguas de Barcelona* to provide water to residents, including in some of the most

rundown parts of the capital. But these deals are small compared to the immensity of Cuba's infrastructural repair needs. Opening the infrastructure to U.S. firms, moreover, may have political implications that the government isn't yet ready to take on.

De-industrialization over the past 25 years has further reduced Cuba's absorptive capacity. Many key sectors—including textiles, clothing, metals, machinery, transportation equipment, and more—have contracted between 50 and 100 percent. Much of the decline is attributable to the end of subsidized Soviet trade and distortions from the socialist model. The weakness of the manufacturing base on which the Cuban economy must build back will hinder its ability to take advantage of new opportunities.

The bureaucracy—chronically underpaid and, during periods of party dominance, neglected—has to grow into a new role. According to people dealing with them, most government ministries suffer from morale problems, weak decision-making processes, and a lack of familiarity with international practices. If Cuba is to fulfill its economic potential, the bureaucracy will have to anticipate needs, become pro-active in avoiding problems, and overcome their reluctance to give political bosses their best analysis and recommendations even when there's "bad news."

VISION AND PATIENCE

The limits on Cuba's ability to absorb a rapid expansion in tourism, trade, and investment are significant, but continuing U.S. controls are also imposing obstacles. The Obama Administration has chosen not to use its executive authority under the Cuban Asset Control Regulations, written into the "Libertad [Helms-Burton] Act," to expand trade with state-owned enterprises beyond those currently licensed—in agriculture, pharmaceuticals, telecommunications, and for environmental protection. Apart from these exceptions, trade is only permitted with small entrepreneurs, who have minimal capacity to import and export. These limits, which can be reduced through executive action, pose a major hindrance to the broader normalization process.

Cuba's challenges in taking advantage of new opportunities are not insurmountable—with political will and time. Havana's approach to change usually has been gradual and halting,

but change *a la cubana* has also been significant. Since the start of the disintegration of the Soviet Union in 1989, Cuba's economy and economic culture have changed more than the government's socialist slogans would suggest—and further change is certain. The economic contract between the people and the government has changed drastically as hundreds of thousands of workers have been laid off, social services have been cut, and the Cuban people have been admonished by President Castro to embrace reforms “without haste, but without pause.”

The pace of reform and corresponding expansion of Cuba's absorptive capacity may be maddening slow for many Cubans and Americans alike. But insofar as the U.S.-Cuba normalization process is irreversible, so too is the conviction in Cuba on the need to “update” the systems through reform in order to take advantage of the opportunities it brings.

The challenges implicit in change are not new, and not unique to Cuba's relations with the United States. Potential U.S. partners eager to engage are about to learn what their European and Canadian counterparts have long known: even with clear incentives on the table, Cuba proceeds at a pace that maximizes its own stability and advantage—which most often means slowly. Those concerns naturally will be especially intense as they inform dealing with the United States, which still rationalizes expansion of commercial ties in terms of the desirability of promoting democracy in Cuba. But Cuban national pride and the Communist Party's fear of losing control could very well be assuaged as the island experiences the benefits of the engagement. Foreigners, especially the United States, who push too hard, too fast, and too haughtily could fail and even delay this aspect of normalization, just as Cubans who move too passively, too slowly, and too skeptically could stymie the process as well.