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AQ FEATURE

Some Contradictions in Contemporary Cuban Economic Development

BY Ricardo Torres Pérez

Inefficiencies and ideology get in the way.

In an August 2010 address to the Cuban National Assembly, President Raúl Castro unveiled a plan that would irrevocably alter the Caribbean nation's trajectory. As part of a broader package of economic changes to increase productivity and exports in a number of sectors, the government planned to lay off 1 million state workers over the next five years, half of those in just six months. The announcement was based on the basic principle that the state could no longer afford to keep unproductive companies afloat and provide the public services—like universal education and health care—that are key to Cuba's socialist model.

While Cuba is no stranger to economic crises, this time the proposal appeared to be well grounded and more in line with contemporary economic trends. To pick up the slack shed by the public sector, the Cuban government introduced a number of economic "updates," known as *lineamientos* (guidelines), to the Cuban economy. The idea was to create space for private-sector growth by granting more licenses for Cubans to employ themselves—an incremental first step grudgingly taken toward a more market-friendly system.

Over the past three years, the *lineamientos* have come to embody the contradictions that are ubiquitous in Cuba. On the one hand, the country's leadership admits that its economic model—one that has remained largely unchanged since 1959—is plagued by inefficiencies and will require a massive overhaul to survive. Yet on the other, the *lineamientos* have been implemented slowly—reflecting the inertia, dogmatic thinking and decades of isolation that have long afflicted the country.

Chronic economic imbalances are endemic to many of Cuba's sectors—from natural resource extraction to foreign investment—and they underline the tension between the recognition that reform is necessary and the limitations that prevent Cuba from realizing its potential for economic development.

Energy, Agriculture and Foreign Dependence

In late May, the Russian state-owned oil company Zarubezhneft abandoned efforts to explore offshore oil reserves off Cuba's north-central coast. While the company vowed to reboot the project next year, the news all but dashed Cuba's hopes of discovering its own oil reserves and lessening its dependence on energy imports. Cuba currently receives 100,000 barrels of discounted oil per day in exchange for sending doctors and other technical staff to its closest ally.

The pursuit of oil independence—and greater reform to Cuba's energy sector—is critical to the success of the current reforms and, ultimately, to Cuba´s sustainable economic and social development. And yet, while Cuba has historically been considered a relatively poor country in terms of natural resources, it enjoys an ample supply of resources that are essential for both energy and food production.

Cuba's challenge is changing how existing resources are actually used.

Currently, the nation's overall energy vulnerability is high. Acquisition of oil and other hydrocarbons represent some 40 percent of total foreign purchases and is highly concentrated in the Venezuelan market. This constrains the resources that could be used, for example, to purchase capital goods that would better support long-term development—and the dependence on fossil fuels takes a huge toll on the environment.

It is essential to devise a coherent policy that allows Cuba to better use its immense potential. The best options for home-grown energy sources are sugar cane and forestry biomass. Elsewhere, for example in

Brazil, modern technologies are able to generate electricity and ethanol from sugar cane, and produce biogas from waste. But sugar cane production in Cuba has, in fact, decreased more than seven times over since 1990. The reasons are varied: loss of favorable terms of trade with the Soviet Union; lack of investment, spare parts and key inputs; an inward–looking strategy; and a low degree of diversification. All of which have narrowed Cuba's chances of building a sustainable energy industry.

At the same time, although forest land has more than doubled in the past 50 years, Cuba lacks the technologies to extract energy from biomass.

Opportunities also abound in solar and wind energy. One study carried out by a Cuban university showed that up to 49 percent of the total domestic demand expected in 2030 could be met by solar and wind.[1]

Another signature Cuban export, tobacco, has also increased exports in recent years, despite the prohibition on Cuban cigars in the world's largest cigar market, the United States. Photo: Reuters

Cuba's prospects for leveraging its rich agricultural potential are also problematic. Although land availability is scarce (0.59 hectares per resident),[2] 60 percent of the island's total area is considered agricultural land, and 54 percent of the water extracted annually is used for agriculture. But although approximately 20 percent of the workforce is nominally employed in this sector, between 15 and 30 percent of agricultural land has been underused for most of the past decade. Yields fall well below both the global average and that of countries with comparable crop supplies—a consequence of an agricultural model with very weak incentives to producers, tight price controls, low investment levels, and little foreign participation.

Today, between 15 and 20 percent of import expenses are dedicated to purchasing 60 percent of the food that is consumed in Cuba. Prices remain high, and a considerable part of household income goes to purchase basic foodstuffs. In addition, the underdevelopment of agriculture corresponds with lost opportunities for residents in rural areas far from economic centers.

Getting Return on Investment in Human Capital

Unlike its energy sector, Cuba has had more success with its system of universal education—one of the pillars of the revolution. When it comes to education, the Cuban government puts its money where its mouth is. In 2011, the state spent 12.7 percent of its GDP, or 19.2 percent of all public spending, on education. On average, there was one teacher for every seven students, a clear indicator of Cuba's willingness to invest in its own people.

The results speak for themselves. In 2010, the average Cuban citizen received 10.57 years of schooling,[3] the highest total for any country in Latin America and the Caribbean, and one of the highest in the developing world (behind only South Korea and Taiwan). Cuba excels in the education measure of the UNDP's Human Development Index, with 87.6 percent of the maximum score, again leading Latin America and the majority of the underdeveloped world (aside from former socialist countries and others in East Asia).

However, Cuba's investment in education has not yielded a better-qualified workforce—an essential ingredient for development. In terms of both overall growth or performance of industrial and service sectors, Cuba has fared no better than most Latin American countries over the past two decades.

Spending on education—which is especially vital to developing countries with limited resources—must produce economic gains as well; otherwise such efforts will become unsustainable.

Moreover, other areas that are equally relevant to the development of human capital have been given short shrift. Development of information and communications technology (ICT) has received little attention and, connected to that, few resources have been earmarked for R&D. Similarly, few incentives are provided to spur innovation.

A reform of Cuba's education system should put more emphasis on labor market needs, so that both the public sector and the entrepreneurial community can benefit from the skills and specialties of the next generation of leaders.

Financing Development

Cuba is a small and underdeveloped country. Its economy needs foreign trade to guarantee sustained economic and social progress. Yet Cuba's savings rates are unable to meet the needs of capital accumulation.

The country's systemic problems are largely to blame. Low median levels of productivity (11 percent of the U.S.'s labor productivity in 2011),[4] and the impossibility of reducing real private consumption beyond certain limits are two contributing factors. Others include the underdevelopment of the domestic financial system, and limited opportunities for the for-profit investment of surpluses generated in certain sectors. The resulting low levels of investment for productive purposes compound the initial problem of low productivity.

To supplement low domestic savings rates, Cuba has tried to tap external sources of savings, primarily loans and foreign investment. Yet the government has limited access to international financial markets, due to, among other factors, its estrangement from the top multilateral financial institutions, poor credit history and U.S. sanctions. Cuba, as a result, is forced to pay high premiums, in turn rendering many otherwise technically viable projects financially unfeasible. For example, prior to the global financial crisis, the Cuban Central Bank issued bonds in the London market in 2007 at rates around 8 or 9 percent—well above what Spain and Greece endured at the height of the Eurozone crisis.

In addition, the nation has depended largely on loans backed by particular governments, such as Brazil and China, presumably at lower than prevailing interest rates. But these have still not been sufficient to cover the needs of the economy.

Foreign direct investment (FDI) is vital to Cuba achieving the "prosperous and sustainable socialism" that Raúl Castro envisioned when he announced the *lineamientos* in 2010. And while the U.S. embargo tempers the prospects for such investment, it by no means stifles it.

There have been numerous examples of successful investment ventures in Cuba that yielded positive secondary effects of FDI. In the energy sector, joint ventures have produced mastery in techniques of both electrical energy generation and hydrocarbon exploration and production. These include horizontal drilling and the use of natural gas to produce electricity and other byproducts used by the chemical and metallurgical industries.

In nickel production, foreign partners have played a crucial role in transforming the plant operated by Moa Nickel into one of the world's most efficient, lifting its annual production to levels exceeding its design capacity. Similar successes have occurred in the tobacco (Habanos), rum (Havana Club International), telecommunications (Etecsa), and tourism (BrasCuba) industries.

But Cuba lacks the mechanisms to scale these lessons up to other areas of the economy. Cuba's aggregate totals of investment in the past 22 years have been much lower than those of other developing countries, even discounting the negative effects of the U.S. embargo. Recent figures estimate that foreign investment per capita has hovered around $300—half that of the next-lowest Latin American country, Nicaragua.[5]

Cuban foreign investment law allows businesses in all sectors except education, health and the military to have a shareholder base that is up to 100 percent foreign. Sherrit, a Toronto-based resource company, is currently the largest foreign investor in Cuba.

But in practice, the daunting approval process for joint business ventures, conducted by the Ministry of External Trade and Foreign Investment (MINCEX), has turned away many potential foreign investors. This is just one example of how Cuba lacks a political strategy for foreign direct investment.[6]

Domestic Market and Social Division of Labor

The Cuban economic model has been hampered by barriers that limit the development of horizontal relations among entities—including joint ventures, buying and selling of contracts and joint R&D projects—fracturing an already small domestic market. This places obstacles in the way of developing structural changes in state-owned firms that could increase productivity and steer more investment toward economic and social development. For example, many firms would benefit by focusing on their core expertise and outsourcing the more inefficient parts of the production process. Instead, Cuban firms are hamstrung by excessive centralization, by bureaucratic barriers established between provinces, and even by the use of different currencies.

In Cuba, policy decisions are made by high-level planning bodies and trickle down. The time span of the entire decision-making process is quite long, as proposals must be discussed and approved at all levels before state-owned businesses can implement them. Additionally, since these proposals generally involve the use of resources, such expenses must be included in the annual plan of both the entity and its corresponding ministry. Approval is granted only if required resources are available, according to the external balance sheet.

In other cases, associating with or establishing a certain type of trade is prohibited or limited administratively. This affects, in particular, service enterprises that are assigned to a specific province or municipality, and those that deal directly with their designated ministries. As a rule, they can only buy, sell and contract with pre-approved entities. The same is true for certain types of property, although these laws have improved in the past year. The hurdles are even higher if the counterpart is a foreign company, where transactions are highly scrutinized and require more approvals.

These overlapping limitations reveal another factor of inefficient economic management. Businesses are required to continuously improve their performance, and indicators are established to measure progress; but regulations prevent them from responding quickly or efficiently when they identify new opportunities.

While Cuba needs foreign investment to supplement its shrinking public sector—and the *lineamientos* are meant to address this need—the laws currently on the books don't create a sufficiently favorable investment environment for it to compete with other economies in the region.

Integration in International Markets

Around the world, trade has come to represent an increasingly large proportion of total production, especially for small economies, due to the limitations of a reduced domestic market. Although this is often an obstacle, some countries have managed to transform this structural characteristic into an opportunity to speed up economic growth, production changes, and modernization. Examples include Singapore, South Korea, Taiwan and, in Latin America, Chile, Costa Rica and Uruguay.[7]

Historically, Cuba has recorded a persistent trade imbalance, driven by a high import rate coupled with a less potent export sector.[8] Cuba's export performance lags far behind the rest of Latin America[9] when measured by export intensity (exports per capita) and the weight of foreign sales within total aggregate value (exports per GDP). This affects areas like business infrastructure, general logistics, production regulations, and preferential trade and investment agreements.

These shortcomings pose serious challenges to Cuba's future development. A viable strategy for economic growth requires strong integration with international trade and investment flows, as well as tools to balance the needs of national and local development with the pressures of the global economy. Cuba has long blamed its problems on its relations with the U.S., but it can make real headway through trade and economic integration with its other neighbors in the region. The advantages of such a strategy may be dawning on the Cuban leadership, as Raúl Castro now leads the Community of Latin American and Caribbean States (CELAC). The maturing of these regional agreements should fortify Cuba's competitiveness going forward.

At the same time, Cuba enjoys a wide network of partial trade agreements with most Latin American countries. But again, these are not used to their fullest potential due to Cuba's limited supply of resources.

Where Economic Need Meets Political Will

While the *lineamientos* are a significant step toward a more sustainable system, Cuba's starting point pre-reform could not be more complicated. Difficult decisions lie ahead.

The internal economic cycle is at one of its lowest points since the collapse of the socialist bloc, and this is not only due to external factors. Though the economy has been growing for the past 19 years, it has not been dynamic enough to respond to the needs of the population or to create a solid foundation for future growth. In fact, issues have piled up in areas such as infrastructure, housing, public transportation, and food. Since 2009, external conditions have become more severe, underlining the country's extreme vulnerability. Cuba's tourism and nickel industries—two key productive sectors—have been especially affected.

More favorable external scenarios, such as a gradual return to international financial markets, along with a closer relationship with multilateral organizations or regional blocs such as the European Union, could help consolidate the economic transformations. They could create a more benign environment, and the possibility of normalization of diplomatic relations with the U.S. could be crucial.

But genuine transformation depends on domestic initiatives that will produce a long-lasting and systemic impact. These include: a new foreign investment law that takes into account both the nation's needs and the international environment, loosening the restrictive regulatory framework of external trade, building a modern financial system, eliminating the dual-currency system, and faster growth in the non-state sector. It takes strong leadership to make this happen. And that is where the reform process will either fail or triumph. Only through reducing the bureaucracy and breaking its resistance to change will the country free up the resources needed to spur growth.

Economic development is key to pursuing ambitious social goals. Incremental steps will not take Cuba much further. Resolute action is needed, and the Cuban people are waiting.

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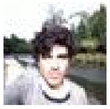

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  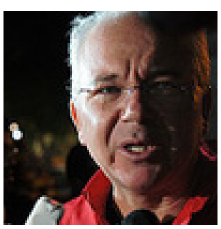

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