Unedited Transcript

Event

Next Steps in US-Cuba Economic Relations

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Marcus Noland: Good afternoon. My name is Marcus Noland. I’m the Executive Vice President and Director of Studies here at the Peterson Institute, and it is my honor and pleasure to welcome you to today’s event on economic normalization between the United States and Cuba.

We have three speakers today and we will invert the traditional practice of presenting age before beauty by starting with PIIE Research Fellow, Barbara Kotschwar followed by Reginald Jones, Senior Fellow Gary Hufbauer and Augusto de la Torre, Chief Economist for Latin America and the Caribbean at the World Bank.

Barbara has written a number of books and articles. Most critical for today’s event, Economic Normalization with Cuba: A Road-map for Policymakers. This publication is for sale in the lobby at a significant discount and if you don’t already have a copy I would urge you to go out and get one.

Our second speaker, Gary Hufbauer, is one of these individuals who in front of this group literally needs no introduction. He is the Reginald Jones Senior Fellow here at the Institute and he has written so many books and articles that rumor has it that forest preservation societies worldwide go cold with the very mention of his name. He is co-author with Barbara Kotschwar of the highly topical Economic Normalization with Cuba: A Road-map for US Policymakers, which is on sale outside.

Last but not least, and here at the iconoclastic PIIE, we not only put beauty before age, we put the host before the guests, is Augusto de la Torre, Chief Economist for Latin America and the Caribbean at the World Bank. Prior to joining the bank Augusto was President of the Central Bank of Ecuador and an Economist at the International Monetary Fund. He did
not participate in writing *Economic Normalization with Cuba: A Roadmap for US Policymakers*, but I’m sure he believes it’s a very fine book.

After each of the presenters have spoken we will have an open discussion and as a consequence I have the speakers, who have enormous amounts to say, to try to limit themselves to leave ample time for discussion of this both interesting and controversial topic. So with no further ado, I would like to welcome Barbara Kotschwar to the podium. Thank you.

Barbara Kotschwar: Thank you very much, Marc. That was quite an introduction. I don’t know whether Marc mentioned that the book, *Economic Normalization with Cuba: A Roadmap for US Policymakers* is on sale at a significant discount in the lobby. But it is, and so it makes great Christmas presents and I guess, Valentine’s Day presents for your loved ones.

My job is to just set the stage for recommendations and an analysis of some of the pressures that may help to shape the next route on this road.

When we first wrote this book we had in mind the fact that the winds of change were blowing gently in both countries and we looked at some of the relaxations under the Obama Administration of things like travel, allowance of people-to-people, trips, and increases in remittances and we looked at the economic reforms taking place in Cuba and we thought that we should probably take a look at this because something might happen in the next three to five years. And so we were quite surprised on December 17th when the two presidents announced their intention to increase normalization of diplomatic relations.

I was actually on the tarmac on an American Airlines charter flight at the Jose Marti International Airport and as an American couldn’t access internet through my cellphone, which hopefully will change with this changes in the regulations, and was informed of this by a very kind seeming farmer from Michigan who was in Cuba on one of these people-to-people exchanges, and said this is a historic day and I thought he meant because he was there on a people-to-people exchange and had been meeting with Cuban farmers and this was impossible before. And so I said yes, this is very important. He said, no, you don’t understand. They made this announcement. And I thought the Michigan farmer probably isn’t going to lie to me and when I arrived in Miami, realized by the questions from the immigration officials who are really interested in what is the best hotel to stay in in Cuba, that this was indeed true.

The winds of change have accelerated and we’ll see where they go from here. The changes in regulations that were announced on the US side allow increased travel. You now no longer have to get a specific license as
long as you fall into one of the twelve categories of allowed to travel, which unfortunately doesn’t include tourism but lots of different categories in which probably most of the people in this room could fall, including business training and support to farmers and this is important in terms of setting the stage for what we hope to be a greater economic relationship between the two countries and greater competition.

Travelers are allowed to now import up to $400 of Cuban goods per person, including $100 in cigars and rum. Remittances have been raised and this is significant. US remittances to Cuba are estimated at about $2.7 billion; a significant part of the Cuban economy quadrupling. The allowance and remittances should have a significant impact on Cuba. US citizens will be able to use US credit and debit cards. This is a significant change and will make things much easier for US travelers in Cuba and for Cubans to receive money from US travelers. MasterCard has already announced that they will start allowing the use of their cards in Cuba starting March 1st, 2015 by US Travels. And then the increased sales of telecom-related goods and services, which anyone who’s tried to access the internet in Cuba probably welcomes this.

In Cuba where Raul Castro’s program of reformed [inaudible 0:06:31], so without any hurry but without pauses continues, the increase in private sector activities has continued. Most of these are relatively low skill activities relatively limited and limited by the limitations the Cuban government still has on economic activity. The travel ban was lifted and has remained lifted, and the new foreign direct investment level, which was promulgated last year has been put into force and the Cuban government has put out a wish list of projects. There hasn’t been a great international response yet, but the hope is that normalization of diplomatic relations between the US and Cuba, particularly if the US removes Cuba from the states sponsors of terror list, will increase also third party investment.

The government in the meeting of the council of ministers, the removal of the dual currency system or setting the conditions for the removal of the dual currency system was set as one of the main priorities for the economic policies of 2015; and Augusto de la Torre will talk to us about that. This is one of the main constraints on the Cuban economy.

Now, Cuba’s economic challenges continue. Growth is expected to be greater in 2015 than in 2014, but Cuba is facing a number of very significant economic challenges. These will have a bearing on how the Cuban government is able to enact its reforms, whether it will be able to continue to have control over the political and economic changes in the county and when and how economic normalization between the two
countries will—between the US and Cuba will occur and so this certainly bears watching.

As mentioned, the exchange rate issue and then estimated assistance from Venezuela, which has been about $10 billion per year according to some estimates. Venezuela as you know, is facing severe challenges both due to its economic policies and the lower price of petroleum.

So we ask are Cuba’s economic reforms even with greater US engagement enough to address its serious economic challenges? And the answer is quite clearly, no, they are not. And Cuba continues to have significant restrictions on economic activity. So predict that the winds of change may blow slowly starting with the fact that the Helms Burton restrictions on US economic activity remain enforced and it does not look as though those will be removed any time very soon. US companies can now sell more to Cuba but the ban on financing remains in place and the ban on significant economic activity continues.

On the Cuban side, well US economic—the new regulations were published very clearly. I think many of us were surprised to see those published and come into force within one month. What about implementation on the Cuban side? I think it’s necessary to ask whether Cuba will be as amenable to some of these changes particularly if they occur relatively rapidly.

US will now allow sales of telecom equipment and services to Cuba. How easy will that be to actually implement in Cuba? There are always questions as to whether additional barriers will be placed on the private enterprise. One of the objectives of the changes in US policy is to help support private entrepreneurs in Cuba. You’ve seen some rolling back of economic activities. Some categories that Cuban entrepreneurs had tried. For example, selling clothes now is restricted to selling home-made clothes. You cannot import clothes and then resell them on the Cuban market, that’s still being worked out and it get bears watching to see whether additional restrictions are placed on economic activity.

The Cuban government retains a monopoly on imports and exports and there’s no mechanism yet for private economic actors to engage in international trade then the Cuban state maintains control of employment.

In the book we set out three likely scenarios. Now we need to think about what US negotiators can do to avoid scenario to the big bang within monopoly capitalism in which economic interest become entrenched and serve as obstacles to a more competitive market in Cuba. What can US negotiators do to pave the way for greater competition in the Cuban
economy rather than putting into place mechanisms that would prevent that competition? This would be better for Cuban entrepreneurs, the burgeoning private sector and also for US interest.

So as Gary Hufbauer will set out, US officials need to begin reciprocal economic negotiations. Not doing so could cause unfortunate results that we’ve seen in other transition economies. The normalization could proceed at a much slower pace with greater favoritism of vested interest and US firms and citizens will be pushed to the back of the line for commercial opportunities in Cuba. So Gary is going to tell us how this can be done and then we’ll hear a presentation on the unification of the currency system. So thank you very much. We welcome your questions. I hope I stayed to the time.

Gary Hufbauer: We’ll see if something happens. But meanwhile, so that Steve Weismann keeps his job I want to urge you to buy the book. Steve is our person who gets all our books sold on the market these days.

So turning to the market, I’m going to just give a few ideas about nudging Cuba towards a market economy and satisfying historical claims, neither one is an easy task.

There are a lot of lessons that can be drawn from economic sanctions, but for today’s remarks, there are two which I would say are key, that very top and very prolonged sanctions do not guarantee political change and there are a lot of examples of that. But, the big but here is that with carefully designed carrots we may slowly nudge Cuba, as with other countries, towards a step-by-step approach towards a market economy, and in the case of Cuba, satisfying historical claims.

So, in thinking about this we have to have in mind a strategic goal and I think our strategic goal, that is the US strategic goal, should be trade and investment agreements with Cuba. Not a free trade agreement right away. That’s obviously Cuba’s not nearly ready for that; a lot of obstacles there. But we could have a bilateral trade agreement which was much short of a free trade agreement. We’ve had those in the past. And we could have an investment, a bilateral investment treaty, and Cuba certainly needs investment. The amount of investment in Cuba today as best we can estimate foreign investment is remarkably small. It’s under a billion dollars, which is very small given the size of the Cuban economy.

So those would be kind of strategic goals. But right now how do we get there step-by-step? And I have laid out—this goes a little bit beyond our book because things have—as Barbara had mentioned they moved much more quickly than we had guessed or anyone had guessed. But these
would; based on principles that I would recommend to the Administration and to the Congress. Allowing export for cash of consumer goods and intermediate inputs; that’s cars, that’s food stuffs, that’s all those great consumer goods.

I know the argument would be that somehow the Castro government will cease part, but it’s a little harder for them to cease part of the money that is being paid for the goods than on the other way around. So, and this speaks to US interest, which have been pretty well frozen out of the Cuban economy now for 55 years. But I would condition exports of capital goods and finance on a numerated market economy reforms, and I would suggest applying a very strict filter on imports from Cuba. I mean, Cuba wants the money. This is where Cuba is more likely to see room for constructive negotiations and the conditions should look for a meaningful concession and were appropriate compensation.

It’s not long before the World Bank and the American Development Bank and the IMF jump into Cuba. They have teams, and Augusto is one of the experts on this who are prepared intellectually and have followed Cuba for some time and if they’re given the green light they can provide a lot of assistance for Cuba. But, the but from my standpoint would be that the international program should be advancing the market economy reforms.

But the final point I would say in these guiding principles is to be sparing on the retention of sanctions for political goals. And I would apply this little litmus test. Would we do it against China if they had this, whatever the political aspect is? And if we wouldn’t do it against China why apply or retain those sanctions against Cuba?

Okay, that the guiding principles. Let’s turn to the menu. I would suggest that amends the Helms Burton law or repeals the Helms Burton law, congress should give the president a menu of quid pro quos, that is things Cuba should do in exchange for US concessions. And I’m going to give some illustrious suggestions, but my recommendation to the Congress should be not to be too strict. Give the president room to mix and match and this just goes not only to the president but also the next president. Who knows how fast things will go, as Barbara said, during the remaining years of the Obama Administration but we can think about the next administration as well. Give the president some room but give him some guidance.

So here are some illustrious suggestions. President Castro has, or he said he wants Guantanamo returned and that’s no surprise. I would suggest that the return of Guantanamo to Cuba could be conditioned on the creation of a compensation fund, at least in principle for justified historical claims by
Americans who have lost property in Cuba. Coming more concretely there is this big category of potential US pleasure tourist, and we go into some numbers in the book, another reason to buy it. But the volume could be enormous of pleasure tourists into Cuba, American pleasure tourists. But I would suggest that we could think about a strict first allowed quota, that is on tourists going to Cuba and then progressive enlargement of that quota could be conditioned on such things as licenses for US hotels, which currently have no presence in Cuba and resorts likewise, though many other countries have their hotels and resorts in Cuba. And possibly Cuban payment, Cuban payment, into a compensation fund of a fairly small amount, $100 per tourist.

Likewise, Cuba could be assigned a sugar quota. Again, we go into the history in the book that a long time ago Cuba had a big sugar quota. Now it has none. Sugar is a very valuable product in the US market because of all kinds of wacko policies we have. But in any event, Cuba could be allowed to participate in that but pay something into this fund.

Other ideas on the finance side. US firms could be permitted to finance defined projects provided Cuban construction workers are paid a reasonable minimum wage and that ties into the exchange rate issue which Augusto will be talking about. But the way the Cuban economy works, most workers get absolutely abysmal wages because they are paid in this national peso which has very little value. Likewise, exports of capital goods, which are going to largely increase the Cuban economy a lot, could be conditioned on most favored nation treatment. That is whatever treatment Cuba gives to Brazil or to Canada should be given to US firms and national treatment, with respect to dealings to state owned enterprises, as Barbara said, much of the economy, in fact most of the economy, big economy or state-owned enterprises, so dealing with them will be big part of the future.

Just a couple of other ideas and then I’ll stop. Bulk imports. Barbara mentioned the travelers can bring back $100 of Roman cigars, but bulk imports of these could be conditioned on an access to US firms to produce such goods in Cuba. Brazil already is producing sugar in Cuba and there will be other examples as well, but US firms are not there personally.

Finally, and this is a big one, but Cuba is well known and rightly known for its healthcare and one could envision that clinics might be open in Cuba to treat Americans who wish to have treatment there, especially at the older end of the age spectrum and such payments could be conditioned on US-owned clinics being allowed to operate in Cuba.
Well, you could go into a lot of other ideas, and people in this room I’m sure will have them. But the idea is to have this step-by-step approach where no one step is so gigantic that it seems to threaten the Cuban government but each one step-by-step gets towards a market economy. Thank you very much.

Augusto de la Torre: Thank you. It’s great to be here and thank you for the invitation to join this very interesting conversation. I am going to talk about something that’s very, in some sense much more particular topic, but in my opinion it is the most important micro-economic constraint to progress in Cuba. So bear with me a little bit because there will be some elements that are a little bit more technical, but I’ll try to keep it at a high level policy level.

So this is based on a paper that’s available. I hope you can get it outside or through the web, written together with my co-author Alan Isse and it was in response to a request by the group consisted to use economic theory and the experience of Latin American countries to help think on how one can deal with this very complicated problem of exchange rate, dual exchange rate system in Cuba. So, I have a few slides to show you. First you need to understand how the system works. It’s very complicated but these are the basics.

Cuba has two currencies and two exchange rates. And people sometimes confuse them. They are two different things. The exchange rates, they are something called the Cuban peso, CUP. There’s something called CUC which is the convertible currency. So the Cuban peso can exchange one-to-one for state enterprises, one-to-one to the dollar and for public institutions, but the same Cuban peso exchange 24 Cuban pesos per dollar for the rest of the folks. And then you have this other currency, which is the CUC, which is one-to-one to the dollar. The two systems responded to different motives. The dual exchange rate regime, one-to-one and 24 to one, is essentially a response to an external shock when they lost the aid from Russia and the terms of trade collapsed and so to protect scarce for an exchange for basic imports they opened up this two exchange rates.

The CUC, the new currency, responded to their desire to avoid the dollarization of the economy. When your currency becomes weak, people like to hold dollars so the Cubans said instead of holding a dollar, why don’t you hold this thing that I called CUC, which is going to trade one-to-one to the dollar? And so that’s the reason. So it’s important to keep thing in mind because the unification of the exchange rates does not need to coincide with the unification of the currencies. Cuba could unify the exchange rates and yet keep two currencies. Like Costa Rica has a local currency and people use the dollar too.
Cuba could unify the currencies and not the exchange rates. So when you think about the exchange rate system in Cuba really you have three different challenges that are conceptually and practically different. One, is whether and how to unify the exchange rates. Two, whether and how to unify the currencies, and three, what would be the exchange rate you put in place after you unify? Each of them is a gigantic micro-economic task.

So to understand the challenge you have to understand what’s special about Cuba in each exchange rate regime. And so I find four very important distinguishing features called the Cuban Case that are not often found in other cases of multiple exchange rates. You now have a multiple exchange rate system in Argentina and Venezuela. Those do not look like Cuba’s in these four important respects.

First, the dual exchange rate system in Cuba originated on an external terms of trade and external aid shock. It didn’t originate as it did in Venezuela or in Argentina on capital flight. People decide to take their assets out massively and that may force the dual exchange rate system. In Cuba it was due to a real external shock, which for me gives a little bit of hope that as you try to unify the exchange rate you will not need to deal with this very complicated phenomenon of capital flight and financial turbulences. That should make things a little bit more manageable.

Second, and you can see it here, when you look at where countries are before the unified exchange rates two things seem to matter a lot. First is what’s my inflation rate before I unify, and second, how far apart are the two exchange rates before I unify? So Cuba, which is at the end, has the largest historical ever known spread between the exchange rates. One-to-one, 24 to one, the spread is 2,300% spread. There has been no other case in Latin America with such gigantic spread. In favor of Cuba, however, Cuba has a very low inflation rate so the unification would begin with an initial condition of fairly low inflation rate. The low inflation rate favors Cuba’s experience. The higher spread makes it a very complicated challenge to deal with.

The third, and this is perhaps the most important feature of the Cuban case, the dual exchange rate regime in Cuba is a fiscal scheme. It is the way through which the state gets revenue. The bulk of that central government revenue in Cuba comes from the difference between the two exchange rates. How does that work? Because there’s a part of the economy that operates with a one-to-one rate. Those are the state enterprises, the foreign hotel operators but the foreign hotel operators that operate with a one-to-one rate, when they pay wages, they pay the wages of the labor to the government employment agency, so the workers don’t get the wages paid in the hard currency. The government employment
agency gets a hard currency and it pays the worker with a devalued, much more depreciated exchange rate. So the system is really a big tax on labor. The government gets a lot of taxes labor in enormous, exorbitant way in order to be able to subsidize the one-to-one rate for the public enterprises and for the public institutions.

This is hugely important because the way which labor is tasked is completely contrary to the socialist ideals. The whole state operates in the backs of the workers. The workers get about five cents on every dollar because the government's appropriating that in the middle. And so it’s a fiscal scheme in that sense but it’s also a fiscal scheme in the sense that whoever gets to sell dollars or is forced to sell dollars at one-to-one is heavily taxed. That’s the foreign hotel operators, for instance. And whoever gets to buy dollars at one-to-one gets heavily subsidized and those are the state enterprises. So you have a huge system of tax and subsidy that’s imbedded in the exchange rate regime.

That has a huge implication. It means that part of your challenge is to separate the exchange rate policy from fiscal policy and in order to be able to do that, one needs fundamental fiscal reform and that creates a major complication to getting out of the dual exchange rate regime. You need a modern tax and subsidy system to replace the use of the dual exchange rate regime, so that’s a hugely important characteristic that distinguishes Cuba.

And the last one, of course, is that Cuba is not yet a market economy. It’s far from being a market economy. So why would you want to unify the exchange rate regime? Well, the main reason why you want to do that is in order to get some economic efficiencies. You want economic actors to respond to more realistic price signals. That’s why you want to unify the exchange rate, otherwise why would you want to do it? So you’re expecting to get some efficiency gains. That’s their [inaudible 00:31:49] of unification. But in a non-market economy actors do not respond flexibly to price signals so you have to do this big thing and you’re not going to get as much of a response from the economy as you would like and that means that the pain of unification is going to be huge in the short run. The gains will come in the medium realm and will come slowly.

So I want to argue, and this is the slide that I’m going to jump quickly, but I want to argue that the dual exchange rate regime is the most important in overarching binding constraint to growth in Cuba. It entails all sorts of inefficiency losses, starting from the fact that I told you it’s a huge tax on labor, but it creates a fault of pricing and valuation because with those exchange rates you really do not know what’s the value of assets, what’s the value of things, and you have very little information on what is the
relative scarcities of resources in the economy, so the effects of this dual exchange rate regime are very pervasive.

Another important effect is that it introduces a major wedge between the interest of the individual and the interest of society because once you have these two exchange rates, the name of the game in Cuba is try to somehow earn the hard currency and that’s why you have doctors driving taxis, kind of in stealth fashion, it’s illegal, to earn the hard currency. In one good day of taxi driving in stealth fashion they make more money than what they make in one or two months as doctors, so society suffers in that the most talented people in the economy are using their talents to try to capture hard currency through unskilled activities instead of healing the population or teaching the kids or whatever.

This is the other reason why you have so much prostitution in Cuba because one way to get access to the hard currency is to sell sexual services in the tourist industry, o you have this dichotomy between private and social interest which is exactly the other way of saying, here in the United States it’s very well known, it’s the failure of the invisible hand. The reason why we like market economy is that sometimes when the markets work well, you get this invisible hand effect where individual people decentralize decisions in pursuit of their own private interest somehow get aligned with the social interest. The dual exchange rate regime in Cuba separates social and private interests in ways that are extremely offensive to the socialist ideals.

So this is a mess and the costs are immense. But getting out of it is very difficult because of this idea of short term pain versus long term gain. So the raw impacts of unification initially will be immense. They create enormous transfers between winners and losers, between losses to losses that are subsidized, windfall gains to losses that are now taxed. So this would be remarkable. It can produce a lot of dislocations. You can have import dislocations that can wreck your economy. And in the short run, the pain can very easily dominate the gain and render the whole experiment enviable.

That’s why one has to be careful on the conditionality that one—I mean the United States or other countries put on Cuba, because if you squeeze too much the conditionality you will render reforms like this even more difficult than what they are to start with. So if you want to really design a system of unified exchange rate regime what you need to get right is the transition and the transition has to meet the two criteria I have in red there. The transition has to somehow cushion the short term pain and cushion the pain until the gains begin to materialize as the economy responds to the new relative price signals.
And then somehow the transition has to accelerate the gains, has to accelerate supply response as part of entrepreneurs and consumers, and it has to be done in a way that ensures the viability of whatever comes next. That’s why I argued in the paper with my co-author that it would be best to unify at the 24 to one rate, although the Cubans would like to unify at one to 10 or one to eight, that seems to me highly risky. You want to protect yourself against downside risks.

I only have one more minute to go so I want to be able to show you the other slides. But what we do in the paper is we analyzed four options to unify. The first one we call raw big bang, which is the more orthodox approach. You do everything cold Turkey first day and then you die. The second is sector-by-sector gradually. This is what the Cubans are doing. They’re trying to unify an agriculture a little bit, in this other sector, a little bit. I think that’s messy and it’s not going to maximize the gains.

The third option is what we call economy-wide gradually, which is you pre-announce that over the next year you will be slowly, slowly unifying the two rates and later you will get there. We see some pros and some cons there and the one we think should work, because this is essentially a fiscal reform, is to do a fiscally-cushioned big bang. And by that we mean unified exchange rates on day one, but on day one you replace the implicit subsidy and tax that’s in the current system with an explicit lump sum subsidy and tax. This would be important because if you don’t do that on day one of unification foreign hotel operators will make a windfall profit out of this world. And so that’s not the type of pattern you want to follow. So initially you want the system to stay fiscally the same. Give yourself time to dismantle the lump sum subsidies and taxes.

The advantage of this system, the one I like the most, is on day one you not only unified the exchange rate, but on day one you know which public enterprises are most heavily subsidized because in the first day you have to give them the lump sum. And so everybody in Cuba would know that this public enterprise is getting zillions in subsidy and this one is getting less in subsidy and that should create some incentives to do public enterprise reform. I’ll stop there.

Marcus Noland: I will let you in on a dirty little secret while the others are coming up here, which is that sometimes I don’t know how many of these lunches I’ve been to, but sometimes I really need coffee to sort of make it to the end. I definitely did not need any coffee for those presentations. It was absolutely fascinating.
So we will open it up to questions. Please identify yourself and your affiliation and if it is directed to a specific individual please direct it to that specific individual because we have three people up here and we want to keep things moving.

Gary Hufbauer: George, I should have acknowledged that Kathleen Sabino who is here did a tremendous amount of work on this study and we should have recognized her at the beginning.

Marcus Noland: Thank you. Okay, so to start right here. We have a roving mic and then we have a mic sitting up here in the aisle and you can take your pick.

Carter Dougherty: Hi there. My name is Carter Dougherty with Bloomberg.

I have a question for you about what else could be done to open up to the sort of political space around and make changes to the embargo possible. Obama has done what appears to be possible under the law, at least as far as I understand. That makes room for a modest amount of trade, but I wonder whether that makes room for enough that there’s a constituency in the United States that would then really push for ending the embargo. This is not China where armies of companies jump out of their seats to try and make this happen. It’s what, 11 million people, 71 billion GDP, and I have my doubts as to whether 5 or 10 years from now the current relaxation would result in enough sort of two-way economic interaction that there’s politically-vested interest in expanding that. I mean, is there more that could be done under the current law? And I give Gary Hufbauer lots of credit for creative thinking there, but I mean, you need some political opening before that’s going to happen.

Gary Hufbauer: Well, my short response would be that the Congress has to be on board. I think the Administration has gone as far as it can and maybe a little further than the strict interpretation of Helms Burton would allow and there obviously are some congressmen and senators who don’t like as far as it’s gone and those interests in Congress have to be brought. But I think there’s a real potential for bringing him on board because there are many US companies which want to do business in Cuba and they are not shrinking violets and there are many Cuban Americans, especially the younger ones, who would like to have more normal relations and then there would be some possible compensation for those historical claims. So I think there’s a residue, or not a residue, they’re more than the residue; they’re building blocks for pressure on the US side. On the Cuban side it’s a bigger question in my mind.
Marcus Noland: If people in the back want to ask questions there’s a mic here in the center so just come on up. The roving mic is not going to be able to make it all the way back. Yes please.

Rafael Romero: Hi, Rafael Romero from [inaudible 00:42:39] Texas. It’s good to see you guys. For Augusto, I have a question. I know we’ve talked about your proposal to do the idiosyncratic lump sum taxes on each firm and I know you went down to Cuba to present it. My concern has always been the implementation. It becomes a kind of an Orwellian machine to have to administer a firm-by-firm tax. I wonder just how the Cuban authorities react to that.

And to Barbara, the book that you guys wrote and Gary’s is outstanding. I’m not sure if you anticipated $50 oil in the Valenzuela issue. I would want your reactions on that.

Augusto de la Torre: So the implementation of any of the options to unify is extremely complicated and the complications are fairly comparable but they are of different nature. I think the implementation of the current approach, which is to unify a different speeds and a different degrees for different sectors is even worse because you get even more fog into the price signals and you get instead of two exchange rates, you’re going to get 200 exchange rates, and the system will become even more difficult to manage.

However, from a political point of view that’s more palatable because you can start with the less distorted sectors and deal with the most distorted sectors at the end. So implementation difficulties abound no matter what you choose. Clearly the proposal that we have, and I presented this to some Cubans, I was not able to, of course, speak to a lot of the authorities, but the Cuban academics and so forth and so on, the difficulty with the proposal we have is that it is too transparent because on day one you know which state enterprises are more bankrupt and which need to be repaired. Because it’s going to be very difficult to tell the Cuban population for too long why am I subsidizing this particular state enterprise so much at the expense of labor. So the transparency is a bullet that has to be bitten at the beginning and that politically is very complicated.

Other than that, the system we proposed implementation is simple because you can ask the Central Bank tomorrow who sold currency at one-to-one and who bought currency at one-to-one and you know exactly, so you know that this particular enterprise would need this subsidy or this tax. But it is the transparency, that’s one. And the second difficulty with our proposal, which is politically complicated, is that once you put the lump sum taxes and subsidies in place you have to dismantle and you have to be credible in your commitment that you will dismantle them over the next
two years or so, but then political forces will arise to try to keep the
subsidies in place. But at least you have something that is visible for the
people.

So I fully agree with you that implementation issues are gigantic and I
think that the implementation issues that are of a political nature tend to
perhaps be a little more complicated to deal with with implementation
issues that are purely technical.

Barbara Kotschwar: And on the anticipation of the oil price, Rafael, you give us a lot of credit.
Thank you. But we did anticipate that Venezuela’s economic difficulties
would make it difficult for the continuance of the subsidies to Cuba and
thought that that would be one of the factors precipitating a need for
negotiation between the two entities. We didn’t predict it so rapidly and I
think that that is causing pressure on the Cuban government. And some of
the responses, which in the media tend to be seen as Cuba is making
demands, you could see as Cuba is starting to negotiate and perhaps will
bring about change more quickly. But who knows? No, we couldn’t have
anticipated $50 oil, so who knows what we’ll be talking about in six
months down the line.

Marcus Noland: So before I go to the gentleman at the mic I would like to ask a followup
question on the exchange rate issue. You had to go through the material
very quickly at the end, but your fiscally-cushioned big bang struck me as
being somewhat like the dual-track system implemented by China in the
late 1970s in which enterprises were basically frozen into operating on the
existing plan but growth beyond that was done essentially on market
terms.

So my question is this. Suppose we implement your plan and I’m a foreign
investor, an American investor, and I come in with a new project, am I
coming in at a neutral kind of tax subsidy scheme while the old system
continues to sort of adjust the new activities are coming in at a more
neutral system?

Augusto de la Torre: That’s an excellent question and hugely important. The beauty of a lump
sum tax or subsidy is that it does not distort incentives at the margin, so
the lump sum taxes and subsidies only apply to existing enterprises.

If I already have a lump sum tax in my existing enterprise or a lump sum
subsidy in an existing enterprise whatever I do is not influenced by the
fact that I have the tax on the subsidy because whatever my effort is will
be the same irrespective of the subsidy or taxes. A new enterprise doesn’t
have to pay the lump sum taxes and subsidy so the new enterprise has a
little bit of an edge. The old enterprises have the advantage that they
already are in the market. They know the market. They have their installations and their buildings and the foreign hotel operators like Millaa, already have an important market share, but the new hotel operator comes in without the lump sum tax or subsidy and for the new enterprise what will govern is whatever the new tax system is in place, which would apply to everybody.

So the beauty of the lump sum tax and subsidies is that at the margin everybody is the same and everybody is already facing new relative prices, new rules of the game. The lump sum subsidies and taxes are only to deal with the legacy problem of the past in an orderly way.

Marcus Nolan: Yes please.


Gary Hufbauer: Thanks Shaun. You’re absolutely right. These will complicate. They are enormously big issues. We didn’t discuss them at great length in our book. We did discuss them a little bit. So let me just touch on a couple of aspects.

One, is the point you mentioned that many of the claims are by people who were Cubans when they lost their property and are now Americans. Historically the United States or other countries would not espouse the claims of such people. You espouse the claims of your own citizens at the time that the property was lost. However, that historical approach will not work politically in the United States now. So what we need is some kind of commission jointly established which will adjudicate the claims of such people, that is Cubans and their descendants who are now American citizens who lost property. That’s going to be messy and difficult. I don’t think it can be sidestepped.

One supplementary point to that is I think right at the get-go the US government should say it will not espouse the return of physical property to such people. It will be a matter of a monetary adjustment. When you go to the German solution, that was their solution and it was obviously the
right one. You try to return physical property and you have created enormous problems.

Secondly, there are claims by US companies and by US citizens who lost their property way back in the 1960s, and those have already been adjudicated. So that’s known, at least the numbers are known and now then it’s a matter of negotiating settlement terms. Big work for the State Department but very important work. And when we come back to the political constituency I think that constituency will be very important in the normalization process and without appropriate compensation or some compensation it will be a big blockade or a big block to going forward with normalization.

I want to just throw in a gratuitous comment on this exchange rate issue which I agree with Augusto is quite fundamental, quite important. This an issue I would urge the Congress not to get involved in. This is an issue for the IMF to work out with the Cubans and the World Bank, IMF to work out with the Cubans all the fiscal adjustments and so forth. My proposal for the Congress and Administration negotiating with Cuba is much, much more incremental.

And so yes, you might have this grand approach. It might work. It might be very messy. It might not. But the US could insist bit by bit some marketization getting around this exchange rate difficulty going forward.

Marcus Noland: Anders Aslund.

Anders Aslund: Focusing on the Peterson Institution. Thank you very much. I would like to talk about the exchange rate also and what Augusto talked. The conclusion sounds fine to me, but this is much more like the Soviet Union. This is like the Soviet Union 1988 what we are seeing and what happened there was that the state enterprise managers took over, got a massive right which seems to be a process that is happening now in Cuba and then they got the opportunity to privatize their arbitration gains from exports and also from imports. So the political economy argument here I would suggest that you add and the other is that look more upon the former Soviet block countries. There you had exactly these kind of exchange rate differentials and that led to very high euro or hyperinflation, which I think would be the natural process if what we are doing now proceeds while you might be able to stop it with your proposal. Thank you.

Marcus Noland: I think that was a statement not a question. Yes please.

Charles Lane: I’m Charles Lane, The Washington Post. A very brief comment qualified question for Augusto de la Torre. I would like to thank you for a
presentation that clarified stunningly that Cuba today is a country that operates based on a super exploitation of labor for the benefit of a handful of military officers and foreigners, which is exactly what they had before the revolution.

My question has to do with your fourth option, the fiscally-cushioned big bang. That fiscal price tag surprisingly is very large. With respect to what Gary Hufbauer said the IMF might be able to handle it but don’t forget that’s US money and Congress might want to have something to say about it. Can you get us any sense, based on your study of the Cuban government, how big a bailout this place needs? Thank you.

Augusto de la Torre: No, unfortunately I don’t think I have sufficient information to get a sense of a bailout. There’s one however, important fact to keep in mind in this option of exchange rate unification that we dreamed of, so to speak, and that is that it’s fully financed because exactly what that lump sum tax is are sufficient to pay exactly the lump sum subsidies and the whole thing comes out to the surface and becomes transparent.

Your point about political economy is hugely important because the managers of enterprises that get huge subsidies have a vested interest in keeping the system and in keeping it nontransparent. So to avoid what you called the big bang monopoly capitalism, transparency is an important tool so to make the financial condition of public enterprises transparent I think is hugely important and that’s what I see as an important merit of this system.

I wanted to say just one point about this interesting conversation that Gary started about things that can be done. I suspect that a couple of things that can be very helpful to ease the process and create incentives for reforms would be, one, to recognize that Cuba does have some comparative advantages. The way I say it is Cuba has comparative advantage in producing certain public goods and is very lousy at producing private goods, but for instance, medical services in Cuba are a notch above the average of Latin America. They have very good system for doctors and for nurses and medical facilities. So any opening along the lines that Gary was suggesting where the US or other advanced countries are willing to buy medical services from Cuba can have a huge goodwill impact on opening up the possibilities of change.

The other thing that I think is very important is that the international community needs to find a way, which doesn’t exist right now, to facilitate a very significant wave of technical cooperation. Cuban officials like Cuban economists, Cuban policymakers, have very limited information on experiences around the world and they are eager to learn
what has happened in Vietnam, what’s happening in China, how transitions are happening and right now the channels to make that information and that technical cooperation available are nonexistent. Institutions like the IDB, like the World Bank, like the IMF really cannot do anything about it under the present system. So I’m thinking about exchange of information and technical cooperation seems to me crucial.

Krista Hughes: Krista Hughes from Reuters. Question for Barb or Gary rather. The bill was introduced to Congress today that would end restrictions on travel and allow banking transactions associated with that travel. Do you expect that bill to pass? And then Gary, just a followup on what you said earlier about perhaps the Administration having gone too far. What could opponents in Congress do to wind back some of those steps that have been taken or to stop any further winding of the policy?

Gary Hufbauer: Turns out we don’t know much about this bill, but my guess is it will not pass and the reason I don’t think it will pass is because it did not deal with the conditionality angle that I mentioned in any way or any compensation issue. Okay, so that would be just my guess. But you may have a better idea on the votes on that and I may very well be surprised.

Now, what can the opponents of the Administration do? Fact is they can’t do very much. They could bring a case. It won’t go any place in the courts. What they can do, and they make the political argument that it’s gone too far, President Obama has gone too far. He’s giving money to Castro. Castro is not doing any reforms. You know the political case as well as I do. So that’s what they can do and they can wait for examples of clear abuse and I think the Administration opened up itself to abuse with its very long list of people who can travel there and it won’t be long before somebody travels and comes back with a very good suntan and whatever and their so-called cultural connections were of the sort that Augusto mentioned and some politician will grab hold of that and then it will be exposed. So I think that it’ll be political opposition but I do think that political opposition will make it harder to do the necessary reforms of Helms Burton.

Marcus Noland: Politicians grabbing hold of it. I think the politicians might be the ones availing themselves with such opportunities. Barry Wood.

Barry Wood: Having just come back from Cuba, these distortions you mentioned, Augusto, in terms of the exchange rate, I mean they may be apparent to intellectuals but I think the average Cuban is not aware that this is offensive to the socialist ideal. Given all those risks, why would the authorities want to move ahead on unifying the exchange rate? Wouldn’t in short-term be easier just to keep it the way it is?
Augusto de la Torre: In a myopic short-term view and just looking at the interest of the current status quo you’re absolutely right. In fact, my anxiety about this is that there may be insufficient incentives to do this reform because the pain and the losers know who they are and they will oppose. The winners are not born yet and they are the Cuban population. They are not organized. So you have that classical collective action problem where losers know who they are. They can organize themselves. They have access. They have voice. They have power. The winners are diffused. It’s the society at large. People that don’t fully understand that and they cannot mobilize coordination, so you have a basic public policy problem.

But the sense I get is that there is a group of high level policymakers in Cuba that understand the cost to the economy of the system. They fully understand that it is a major constraint, that a lot of inefficiency is hidden under this dual exchange rate regime, that it creates awful incentives; makes Cuba very expensive for the tourist to start with because the tourist, whatever the tourist pays doesn’t go directly to the workers in Cuba they go to the different employment agencies. So I feel that there is consciousness.

When I read the [inaudible 01:03:46] number I think 120-something, that describes the need to reform the exchange rate regime, I was amazed with that very modern language that was employed in describing the problems of the system and the need for reform, so there’s this duality between a well-understood problem by some and huge resistance by the incumbents in the status quo for change.

Marcus Noland: Thank you. Lady right here.

Karen DeYoung: Thank you. Karen DeYoung from The Washington Post. Could you explain what restrictions exist under the state-sponsored terrorism list in terms of economic openings that will not go away—that will go away under the restrictions that remain under the embargo if any. And also, do you see any merit at all in Cuba’s claims for compensation? They say they are owed a billion dollars from the embargo. Thank you.

Barbara Kotschwar: I’ll just preface this by saying that I’m not a lawyer so the statements that I make about the state-sponsored terrorism removal, it removes restrictions and it limits the US putting restrictions on financial assistance to Cuba. It eliminates restrictions on some foreign companies doing business with Cuba and allows more—it facilitates payments for goods in Cuba.

Gary Hufbauer: Yeah, I actually know something about this because it applies to North Korea. What it does is, if you’re on the state-sponsored terrorism list, the
United States executive directors at international financial institutions cannot vote for your membership in that institution and if you’re already a member, they cannot vote for loans to be given to you. It, I think, automatically puts you on the [inaudible 01:05:59] list, so we obviously are not going to be sending you any military technology and it has these other ancillary financial restraints that Barbara mentioned.

What’s interesting is that there’s a lot of focus on that list for obvious political and diplomatic reasons, but from an economic standpoint when you look at the actual countries that are on the list and how they may be affected by removal, it’s really almost, or by putting them back on, in the case of North Korea, it’s almost more of a symbolic gesture. The direct practical implications are generally pretty limited.

Audience: [Inaudible 01:06:55].

Gary Hufbauer: Oh yeah, the Cuban claim for compensation for the sanctions. Well, the US cannot tolerate this. They can talk all they want about it. You can read our other book, you could even buy our other book on sanctions. We’ve been sanctioning countries. We’re the dominant sanctioneer and you start allowing some claims where are you going to stop? Russia is going to bring in its claims. This is ridiculous. The Cubans know it’s ridiculous.

Marcus Noland: Yes please.

Peter Strong: My name is Peter Strong. I used to work for the OECD and for the IMF and I’m now retired. I want to thank the speakers for their presentation, which I think was a discussion of reform from an outside perspective. And Barbara conveniently classified three reform models like the Chinese model and the Russian model and the Polish model and made it very clear that from an outsider view the Polish model is clearly preferable.

My question is, is there any clearly formulated idea that Cubans themselves said where do they want to go and do they agree on where they want to go, and is their idea or their plan taking into account or have they actually presented their idea of reform or are they just sort of listening what outsiders say and see how they can maximize their foreign exchange armies? My question is what is the Cuban plan? We know what we think or we think we know what’s good for Cuba. Do the Cubans know what they want and what they consider best for them?

Barbara Kotschwar: Well, I can start. Obviously, I think it’s clear that the Cubans have put a lot of thought into this and recent Cuban statements reiterate that the Cubans like their political model and intend to retain that. They would like to move slowly but surely to a more open market economy in a way that
maintains the socialist ideals. As to how open they are to others I think they are open to others ideas in the way that helps them move towards that goal. How things will actually go may differ from how the US wishes things to go and how Cuba wishes things to go, but I think that Cuba has been rather clear on what their intentions are. They would like to use increased engagement with the United States to help bolster their model, to help increase the welfare of their country, and to continue the model that at least in the official statement some think is working quite well.

Augusto de la Torre: The times that I have visited Cuba for conferences and things like that, I have always been amazed how almost unexpectedly warm the feelings of Cubans are towards the United States. They would like to be able to watch more of the baseball and basketball and they think the US is just a few miles away, so I didn’t feel that there is a strong animosity. There’s quite a bit of excitement about the possibility of having more interaction with the United States.

The balance between economic growth and the ideals of social equity is one where I think Cubans can benefit from international experiences dramatically because the world has figured out how you can get the two. Not always well but you know that you can have a good social policy that creates a fairly equitable society, as you can see in Europe or in South Korea and other places, and yet a very vibrant growing society. But to manage these too, to separate social policy from growth policy is very important in Cuba and they do not really know how to find the path.

Look at, for instance, the small entrepreneurs. They have a lot of small entrepreneurs, the hairdressers, and they sell you shirts and they do things for the tourists and these small entrepreneurs are very active, very creative. They cannot buy their inputs directly, they cannot trade freely, but they are actually doing well and the Cubans do not know how to handle this because they are not used for some people to do much better than others. And so accepting this type of the simple fact of life that more effort, more creativity, may make you better off than others is not something that’s easy for them to see given their history. So they need to figure out a way to accept these differences that result from effort, more creativity, while at the same time making sure that they are not going to be homeless in the streets and that they are not going to have an immense and unmanageable inequality. And this is why I find that they have very little understanding of international experiences of how to balance the two objectives.

Marcus Noland: Thank you very much. As the host of gatherings such as this one walks into the room with a certain amount of anxiety. One is always afraid that when it comes time for the discussion period there will be this dead and
somewhat embarrassing silence, so you have to have at least one question
prepared just to get things going and in this case, I’m not a particularly
malicious person so I was going to keep Augusto and Barbara out of it, but
I was going to ask Gary about the implications of all these for possible
normalization of economic relations between the United States and North
Korea.

Fortunately, the discussion was so interesting and the audience
participation was so enthusiastic that I was not forced to resort to this
desperation move. So I would like you to join me in thanking—well, first
I’d like to thank all of you for spending your time with us this afternoon. I
would like to remind you that the book, *Economic Normalization with
Cuba: A Road-map for US Policymakers* is on sale. I very much like
Barbara’s idea of using it as a Valentine’s Day present. It’s about
normalization. It’s about integration. There’s a kind of romantic aspect to
it. And I would like you to join me in thanking all three speakers. Meeting
adjourned.