Exchange Rate Unification:

The Case of Cuba from an International Perspective

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Washington, D.C.
January 29, 2015

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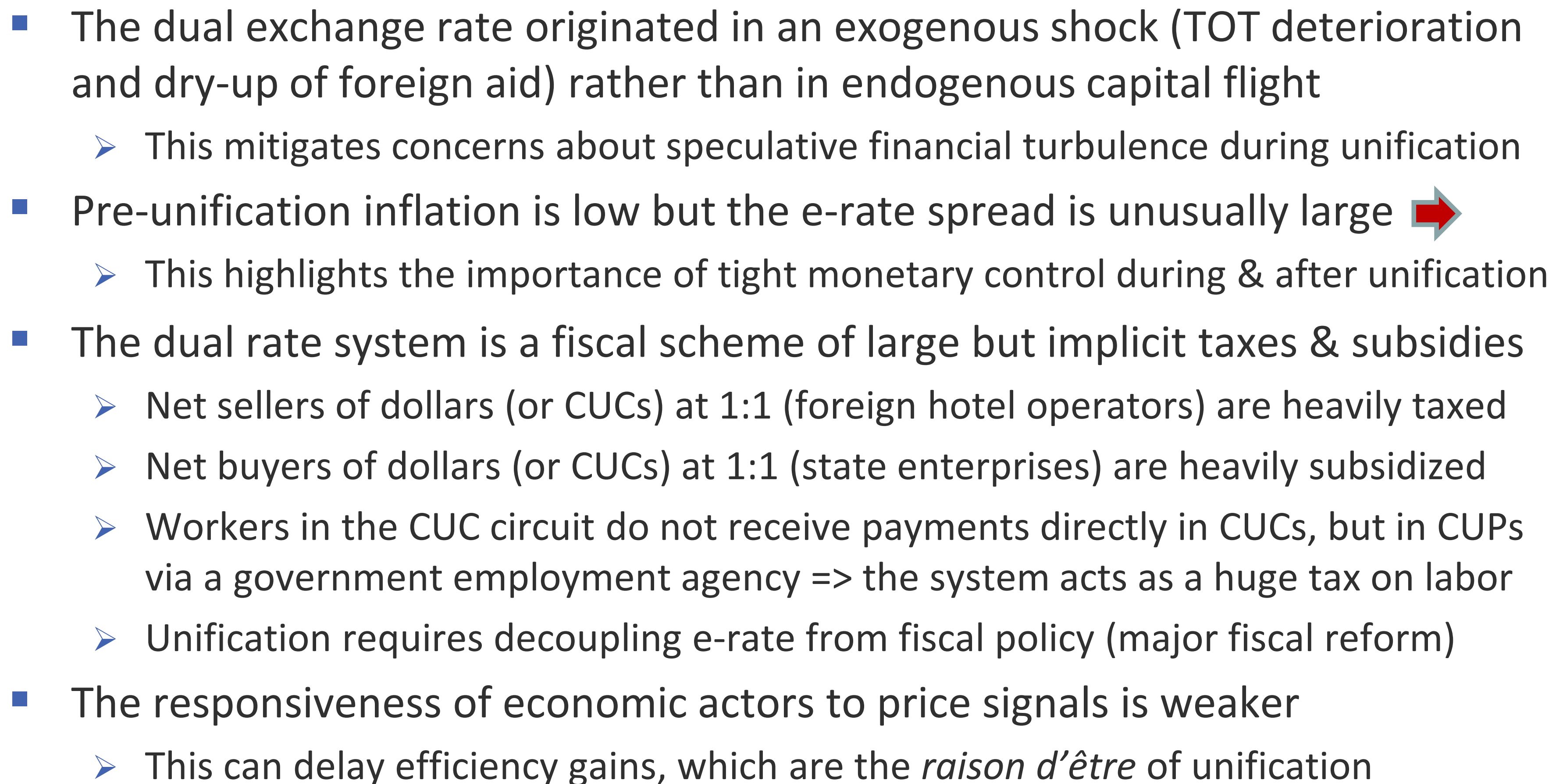
Exchange rate unification vs. currency unification

- The dual exchange rate system in Cuba overlaps with a dual currency system
  - Two *official* exchange rates for the Cuban peso, CUP
    - 1 CUP per 1 USD for the state enterprise sector and public institutions
    - 24 CUP per 1 USD for the rest
  - Two currencies: CUP and CUC, where 1 CUC = 1 USD
- However, the two systems respond to different motives…
  - The dual exchange rate was introduced to protect basic imports and the BOP
  - The CUC currency was created to mitigate dollarization
- …and their unification can be conceptually and practically de-linked
  - The two exchange rates could be unified while keeping the two currencies
  - A single currency could be mandated but two exchange rates could be kept
- Three policy decisions: e-rate unification, monetary unification, post-unification exchange rate regime; the focus here is mainly on the first

What is special about the unification challenge in Cuba?



Post-unification inflation appears to depend on pre-unification spread and inflation

Country	Beginning of Unification Process	Pre-Unification Premium	Phasing	Point-to-Point Annual Inflation			
				3 months before unification begins	*…3 months after*	*…12 months after*	*… 24 months after*
Venezuela	Mar. 1989	200%	Fast	36%	103%	81%	36%
Argentina	Feb. 1989	50%	Gradual	372%	460%	8163%	232%*
Peru	Jun. 1989	165%	Gradual	3414%	5704%	1968%	207%*
Ecuador	Sept. 1992	30%	Gradual	50%	64%	46%	27%
Dominican Rep.	Oct. 2003	10+%	Fast	26%	40%	52%	0%
Cuba	?	2300%	?	4%	?	?	?

*Notes: Premium is defined as the average spread between the parallel and official rates as a percent of the official rate in the last quarter before unification starts. Phasing is defined by the duration of the coexistence of official and parallel rates after unification starts—"Fast" is defined as less than 3 months. * 28 months after, to capture the effects of the formal introduction of Convertibility in April 1991 (Argentina) and the final currency unification in August 1991 (Peru) .*
Sources: EIU, World Currency Yearbook (several publications), AREAER (several publications), Pick's currency yearbook (several publications), Kiguel and O'Connell (1995), Marion (1999), Reinhart and Rogoff (1999), Kamin (1991), IFS database.

The dual exchange rate regime is the most important and overarching binding constraint to growth…

- It entails huge efficiency losses…
  - Implies a heavy tax on local labor, hence the remuneration to workers is excessively low but the labor cost to foreign firms excessively high
    - Cuba is expensive for tourists
  - Creates a relative price and valuation fog that fundamentally vitiates the information on relative scarcities and disables the functioning of input markets
    - Cuentapropistas that earn in CUC do not have access to import markets
  - Introduces a major wedge between individual and social interests
    - Stealth employment in CUC circuit, opacity, enforcement nightmares, rent seeking, etc.
- …which amplify pressures on central government finances and the BOP…
- …and drag down economic and social progress
  - Penalizes employment-generating production of importables and exportables
  - Hinders new FDI
  - Raises costs and undermines quality of tourism services

…but the short-term pain of unification can dominate, hence, the premium should be on transition design

- The raw initial impacts of unification can be quite painful
  - Tug of war between losers and winners, major fiscal revenue losses, productive dislocations, inflation outbursts, regressive distributional effects
- Over time, efficiency gains should more than compensate the pain – by boosting the size of the cake, they should result in a win-win for all
  - But progress towards a market economy and credible rules of the game would be needed for significant gains to materialize
- In the short-run, the pain can dominate as the size of the cake is given
  - Increases in capital stock and reallocations of labor and capital take time
- A successful transition should appropriately balance pain and gain…
  - Cushion the short-term adjustment pain until efficiency gains materialize
  - Boost the pace at which efficiency gains materialize
- … and ensure the viability of post unification exchange rate regime
  - Hence, better to unify at the 24:1 rate

Option one: raw big bang

- ***Policy***
  - Unify on day one the two exchange rates, at 24:1 (to limit BOP pressures)
- ***Pros***
  - Simple and straight forward
  - Potentially most credible (all done on day one)
- ***Cons*** – does not address the pain/gain balance at all
  - In principle, a raw big bang maximizes the gains…
  - …but, in practice, by concentrating all the pain at the beginning…
  - …it may be so traumatic (socially and politically)…
    - Enormous re-distributional and reallocation frictions
  - …as to unleash de-stabilizing macroeconomic (especially fiscal) responses…
  - …which *may render the whole experiment unviable*
  - Hence, the initial credibility may soon dissipate

Option two: sector-by-sector gradualism

- ***Policy***
  - Gradually depreciate the 1:1 rate towards the 24:1 rate on a sector-by-sector basis, in different degrees and at different speeds
- ***Pros***
  - Less traumatic than option one, as the pain is spread over time
- ***Cons*** – addresses the pain/gain balance only minimally
  - Lower-intensity of pain than in option one…
  - … but it is protracted, lasting for a prolonged period of time…
  - …during which it is unlikely to be offset by sufficient efficiency gains…
  - …because much of the supply response would be postponed
    - Policy uncertainty (discretionary adjustments with risk of incomplete reform)
    - Even greater multiplicity of exchange rates (that would segment markets and so distort price signals as to impede efficient resource allocation across sectors)

Option three: economy-wide gradualism

- ***Policy***
  - Preannounce a path of gradual convergence of the 1:1 rate to the 24:1 rate for the entire economy
- ***Pros***
  - Much simpler than option two
  - It is less traumatic than option one (pain is spread over time)…
  - … and avoids the additional distortions of option two during the transition
- ***Cons*** – addresses the pain/gain balance to an insufficient extent
  - The pain is of lower intensity than option one but lasts over a prolonged period (broadly similar in this respect to option two)…
  - …during which the gains are greater than in option two but are likely to be insufficient to offset the pain…
  - There is a clear risk of a self-fulfilling failure: investors wait => raises transition costs => forces abandonment of preannounced path => justifies waiting

Option four: fiscally-cushioned big bang

- ***Policy***
  - Unify on day one the two exchange rates, at 24:1 (to limit BOP pressures)
  - Replace on day one the (dual rate-based) for each *existing* enterprise/institution the shadow tax or subsidy with a dollar-equivalent *lump-sum* tax or subsidy
  - Allow all economic actors (new and old) to operate under the new rules and a consistent (even if partial) set of efficiency-oriented incentives
  - Preannounce a gradual phase down of the lump-sum taxes and subsidies
- ***Pros*** – adequately addresses the pain/gain balance…
  - Lump-sum taxes and subsidies cushion the pain by distributing it over time …
  - … and instantly unveil the true financial situation of enterprises
  - Calculating the lump-sum taxes and subsidies is easy: the central bank knows
  - Relative price changes work their way to maximize efficiency gains from day one
    - Investment/production decisions are totally independent of the lump-sum
- …and immediately reveals true financial situation of state enterprises
- ***Cons*** – requires non-trivial preparation and major changes in economic policy

Currency unification

- Full dollarization would be unwise, as it would
  - Increase Cuba's vulnerability to adverse terms of trade or other large shocks
  - Promote inflation as the main channel for real appreciation
- No clear benefits of maintaining the CUC after exchange rate unification
  - Keeping the CUC as a currency board-based *electronic unit of account* might help re-monetize into CUC deposits while confidence builds up…
  - …however, as long private citizens prefer dollars in cash, the shift of savings towards CUC-denominated deposits is likely to be limited
  - Instead, by fragmenting credit and reducing market depth, the dual currency can hinder the strengthening of monetary management capacity…
  - …and, as long as state enterprises remain as the main depositors, there is little risk of a depositor flight into dollar cash
- **Therefore, combining exchange rate unification with currency unification (mandatory conversion of CUCs into the new currency) seems preferable**

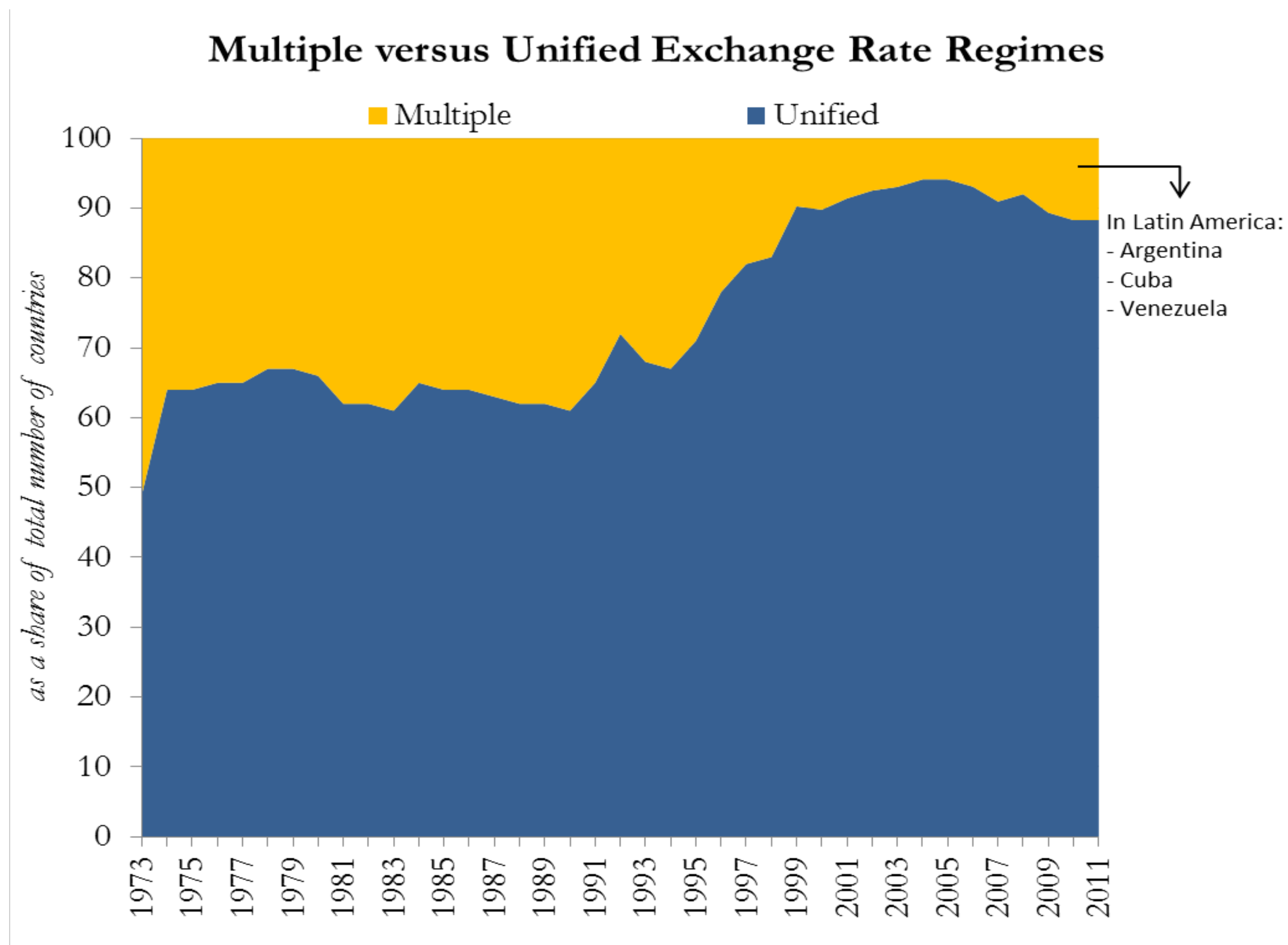
Post-unification monetary regime sequencing

- The fiscally-cushioned unification will require a gradual strengthening of the central bank's monetary instruments and management capacity…
- …in tandem with a gradual development of interbank and exchange rate markets, and sound financial intermediation
- Hence, while a flexible exchange rate would reduce better help absorb shocks and limit de facto dollarization…
- … a realistic post-unification exchange rate regime could follow three phases
  - **Initial**: a fixed exchange rate with control of central bank credit expansion and of excess liquidity in the interbank market
  - **Intermediate**: a flexible (but managed) exchange rate with money targeting
  - **Final**: a flexible (but still managed) exchange rate with inflation targeting

Thank you

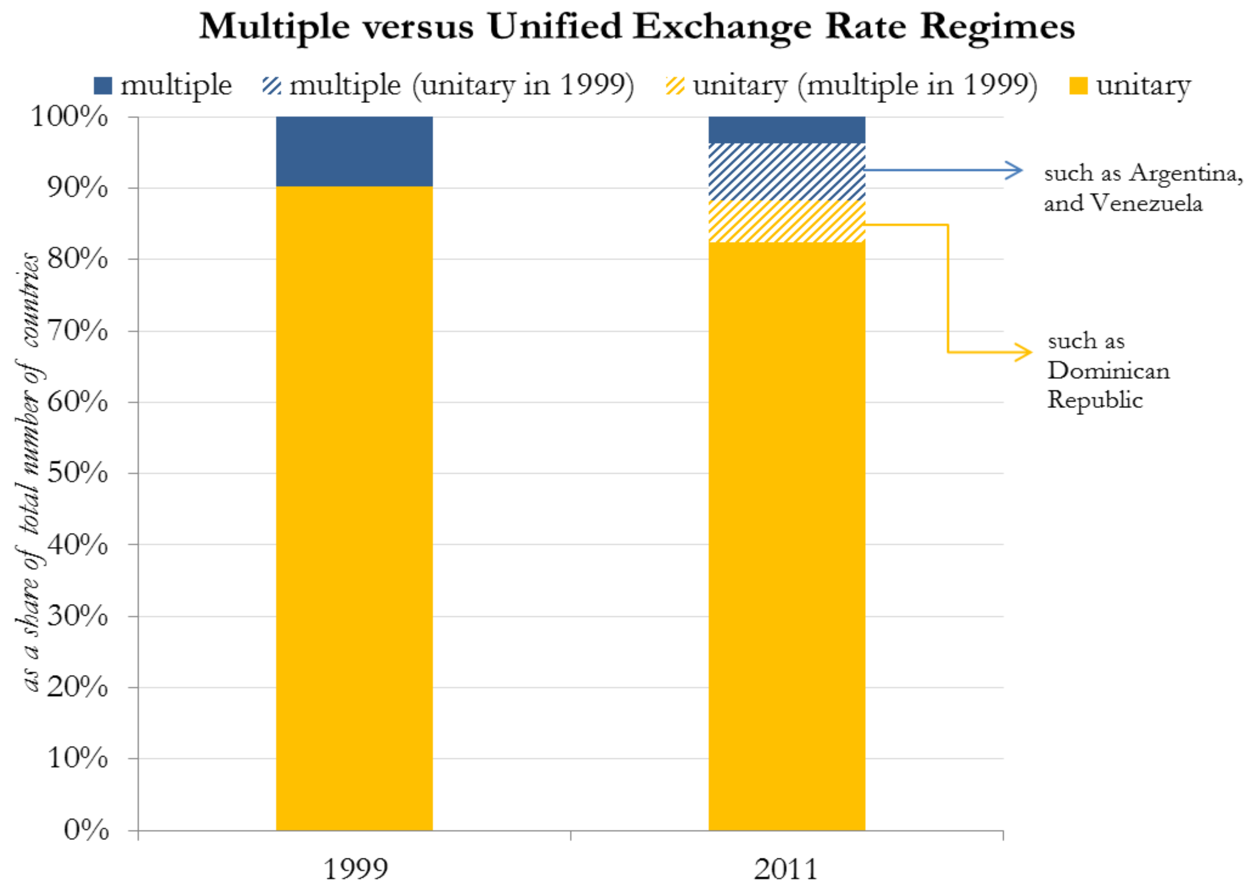
Extra slides

Partly reflecting improved macro management in EMs, multiple exchange rates have become a vanishing breed



Source: Rogoff et al. (2003) and AREAER online database

Significant churning within the small set of countries with multiple exchange rate regimes

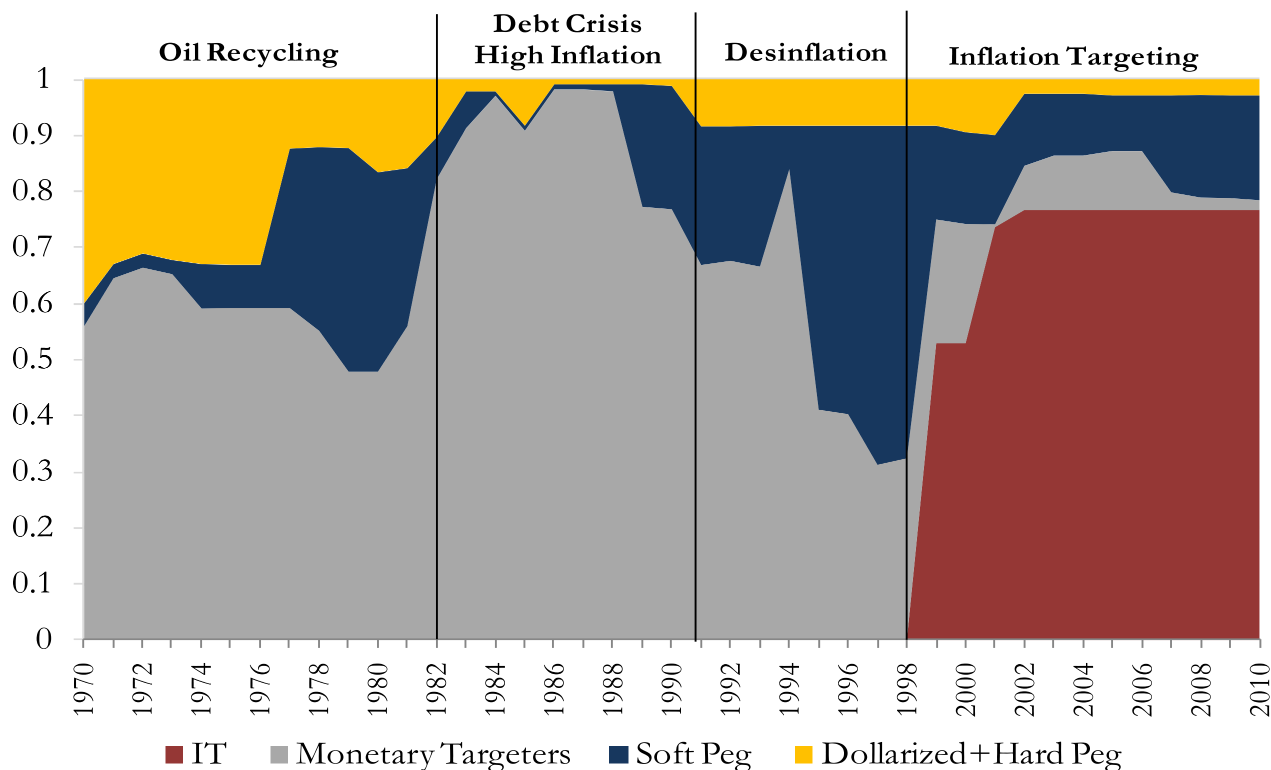


Notes: Countries with multiple exchange rates in 2011 but with a unified rate in 1999 are Angola, Argentina, Eritrea, Georgia, Guinea, Kyrgyz Republic, Malawi, Maldives, Mongolia, Nigeria, Sao Tome and Principe, Sudan, Ukraine, Uzbekistan, and Venezuela. Countries with a unified rate in 2011 but with multiple rates in 1999 are Afghanistan, Belarus, Botswana, Cambodia, Dominican Republic, Egypt, Iran, Lao, Libya, Russia, Turkmenistan. Source: AREAER online database

	1970	1987	1997	2010
Dollarized+ Hard Peg	Argentina Bahamas, The Barbados Belize Costa Rica ECCB Guatemala Guyana Haiti Honduras Jamaica Mexico Panama Suriname Uruguay Venezuela	Bahamas, The Barbados Belize ECCB Panama	Bahamas, The Barbados Belize ECCB Guyana Panama	Bahamas, The Barbados Belize ECCB Ecuador El Salvador Honduras Panama Suriname
Soft Peg	Bolivia Dom. Rep. Ecuador El Salvador Nicaragua Paraguay TTO	Guyana Haiti Jamaica TTO	Bolivia Brazil Chile Colombia Costa Rica El Salvador Guatemala Haiti Honduras Jamaica Nicaragua Paraguay Peru Uruguay Venezuela	Argentina Bolivia Costa Rica Guyana Jamaica Nicaragua Paraguay TTO Venezuela
Monetary Targeters	Brazil Chile Colombia Peru	Argentina Bolivia Brazil Chile Colombia Costa Rica Dom. Rep. Ecuador El Salvador Guatemala Honduras Mexico Nicaragua Paraguay Peru Suriname Uruguay Venezuela	Argentina Dom. Rep. Ecuador Mexico Suriname TTO	Dom. Rep. Guatemala Haiti Uruguay
IT				Brazil Chile Colombia Mexico Peru

Source: Ilzetxki, Reinhart and Rogoff (2011) and LAC Chief Economist calculations.

… but with the bigger countries clearly going towards inflation targeting



Source: Ilzetxki, Reinhart and Rogoff (2011) and LAC Chief Economist Office calculations.

Illustrating the Fiscally-Cushioned Unification

Non-exporting state enterprises

The challenge

- The current system entails huge efficiency losses…
  - Using the 1:1 rate for basic imports and the 24:1 rate for wages amounts to subsidizing basic imports and penalizing consumption of non-basic imports
    - (This may contribute to evening out welfare across Cubans)
  - The implicit subsidization scheme weakens the central government finances…
  - … penalizes the employment-generating production of importables…
  - …and promotes imports of basic goods, putting pressures on the BOP

- …but a "raw big bang unification" would be traumatic on impact
  - While it would improve the BOP and central government finances…
  - … it would generate cost-pushed price increases on the goods produced or imported by import-intensive state enterprises…
  - …thereby triggering supply inflation and contractionary pressures on output
  - By eroding the purchasing power of low-paid workers, it would raise inequality

Using lump-sum taxes/subsidies to balance pains & gains

- The policy
  - On day one, unify the exchange rate at 24:1, so as to limit BOP pressures…
  - …replace the inefficient import subsidy with a ***dollar-equivalent lump-sum subsidy*** that neutralizes the fiscal, BOP, and inflationary impacts…
  - …and ***pre-announce a gradual, multiyear phase-down of the lump-sum subsidy***
  - Direct state enterprises decisions towards cost minimization/profit maximization, conditional on maintaining affordable prices during the transition

- The pain/gain balance
  - It would immediately enhance budgetary and public sector transparency
    - Existing loss making enterprises will come out into the open
  - ***All*** enterprises (existing state enterprises and the new private or public competitors) would operate under new rules of the game…
  - …thereby maximizing the scope for efficiency gains from day one
    - Gains would continue to build up overtime as market price signals improve

Summing up…

	Foreign-managed tourism services	Non-exporting state enterprises
Immediate impact of unification at 24:1	Fiscal losses causing demand inflation	Price adjustments causing supply inflation
Immediate policy response	Lump-sum tax on *existing* enterprises	Lump-sum subsidy on *existing* enterprises
Over time policy response	Phase out the lump-sum taxes	Phase out the lump-sum subsidies

Fiscal, State Enterprise Governance, and Market-Oriented Reforms

Fiscal reforms

- Prepare replacement of shadow taxes/subsidies with transitional lump-sum taxes/subsidies
- Prepare further fiscal reforms
  - Reform the tax system, from the perspective of a new long-term and market-oriented environment (VAT, foreign trade taxes, FDI taxation, etc.)
  - Create a system of (cash or coupon) transfers targeted to the lowest income households to support basic consumption
- A healthy fiscal position would facilitate the transition
  - A *pre-unification* fiscal surplus – to underpin initial int'l reserve accumulation that would subsequently "finance"

Governance and market-oriented reforms

- Governance and accounting reforms would be needed to make state enterprises more responsive to market signals
  - Give enterprises market-compatible mandates (i.e., cost minimization/profit maximization) and assess their performance accordingly
  - Based on emerging market prices, introduce modern accounting practices
  - Establish a plan to close or restructure unviable state enterprises
  - Net out and restructure inter-enterprise claims sheets as needed