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A photograph of a narrow, cobblestone street in Havana, Cuba. The street is lined with colorful, multi-story buildings featuring balconies with plants and hanging lanterns. In the distance, the large, white, domed Capitol building is visible under a bright sky. People are walking along the street, and a small cart is visible on the left. The overall atmosphere is lively and historic.

# Five Steps to Grow the Cuban Economy

## What the US and Cuba Can Do in Obama's Final Year

*By Michael W. Klein and Pavel Vidal*



# Atlantic Council

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# **Five Steps to Grow the Cuban Economy**

**What the US and Cuba Can  
Do in Obama's Final Year**

By Michael W. Klein and Pavel Vidal

# Foreword

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**W**hen President Obama travels to Cuba on March 21, he will see the new private sector forces unleashed since December 17, 2014. More US tourists bring more customers for Cuban small business owners. The elimination of remittance caps allows a greater influx of dollars and capital. Businesses like Airbnb and Sprint, household names in the US, are now operating in Cuba.

The embargo will eventually be lifted by Congress. But in the meantime, the United States and Cuba can start by helping to put in place a working financial system, which would substantially improve the lives of Cubans.

An improved and expanded financial sector will enable new enterprises to access startup capital, provide resources for existing businesses to grow, and open the door for Cuban citizens to borrow for home purchases and needed durable consumer goods. A more modern and efficient payments system will increase the efficiency of Cuban businesses and ease strains on Cuban households.

Achieving these goals begins with a short-term step: laying out the welcome mat for Cuba to enter international financial institutions, starting with

the Inter-American Development Bank (IDB). The Cubans must want it, but the United States is key to unlocking this opportunity. Giving the green light—possible despite current legislation—may be one of the last big, irreversible moves the administration can undertake to empower the Cuban people.

The IDB can help to fix structural obstacles by working to unify Cuba's dual-currency system; address the severe lack of banks and microfinancing; increase access through mobile banking; and rebuilding weak infrastructure through international public-private partnerships. Until progress is made on these fronts, access to serious international investment will be an uphill battle.

The ultimate goal is one we can all agree on: a more vibrant private sector that shrinks state dominance, advances greater economic liberties, and provides better living standards for all Cubans. Atlantic Council authors Michael Klein and Pavel Vidal lay out the five top priorities for Cuba's financial and monetary reform along with recommendations of what both the United States and Cuba must do to move forward. That path begins with IDB membership.

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# Introduction

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**C**uba is at a crossroads. The last year was marked by an unprecedented opening with the United States, unimaginable in November 2014. The European Union is now on the cusp of signing a Political Dialogue and Cooperation Agreement with Cuba. In April, the Cuban Communist Party holds its seventh Congress. And building on all of this, European and Latin American firms are among those stepping up interest in investment. With the world quickly changing, the Cuban government must look carefully at how its financial system must adapt to meet this new international paradigm.

Economic changes are clearly underway. Small private businesses are on the rise in a number of areas, with new flows of remittances and capital coming to the island. Supporting these entrepreneurs is a central goal of US policy. But financial development and monetary reform are also critical for advancing the Cuban economy. They may not garner the same headlines as the trade embargo and travel ban, but both are of central importance to Cuba's success. What is the current state of finance and the

monetary system? And what issues are holding back US and Cuban stakeholders from moving forward with greater global financial integration?

Over the past decade, the Cuban government has made incremental but important changes to its economic policies. But more must happen to achieve the ultimate goal: a more vibrant private sector that allows for a smaller state sector. This will hopefully make the remaining government firms more efficient and able to pay livable wages.

Financial development has an important role to play here. An improved and expanded financial sector will enable new enterprises to access startup capital, provide the resources for existing businesses to grow, and open the door for Cuban citizens to borrow for home purchases and needed durable consumer goods. A more modern and efficient payments system will increase the efficiency of Cuban businesses and ease strains on Cuban households.

Financial steps forward will require monetary reform, one of the biggest and most important challenges facing the government. Today's two-currency



President Barack Obama and President Raúl Castro at the Summit of the Americas



**Capitolio Building in Havana, Cuba.**

system contributes to price distortions that hobble the economy and deter foreign investors wary of grappling with such a system.

The historic steps taken by the Obama administration beginning in December 2014 are critical corrections of US policy. But the US government can do more to contribute to financial development and thus empower the private sector. Of course, the top priority should be to lift the embargo, as President Obama urged in his last State of the Union address. Such action would enable an increased scope of trade between Cuba and the United States.

Other steps can be taken in the interim. An important change in financial restrictions has been the elimination of caps on remittances, but this will disproportionately favor those with American relatives in the Cuban diaspora. Helping a far broader base of the

Cuban population will involve easing restrictions on US and other nations' banks and financial institutions operating in Cuba.

Likewise, US companies, and Cuban consumers and companies, will benefit from the total elimination of controls on financing for US exports to Cuba, and from restrictions that prevent the use of US dollars in transactions with Cuba. The President should also make the necessary policy adjustments so Cuba can be welcomed into the Inter-American Development Bank (IDB) and other international financial institutions.

What else can be done to correct course? After setting the scene, we lay out five of the top challenges to Cuba's broader financial integration and recommendations of what both the United States and Cuba can do to chart a successful path forward.

# Cuba's Financial Landscape Today: Too Few Banks, Too Many Currencies

**C**uba has seen many changes in its financial structure over the past two decades, mostly prompted by the hardships of the “special period” in the 1990s when it had to adjust to the fall of the Soviet Union. Today, Cuba has nine commercial banks and fifteen nonbanking financial institutions.<sup>1</sup> Eight of the nine commercial banks are fully owned by the Cuban state and the ninth is owned by the Venezuelan government.

Banks do not serve retail consumers as in other countries. There is very limited lending to households for home mortgages or car loans, and consumer financial services like credit cards are not provided. Instead, Cuban banks lend mainly to state enterprises and private agricultural producers.

Cuba may have too few banks, but it has too many currencies. The Cuban dual currency system began during the special period when,

with triple-digit inflation, officials allowed the US dollar to be used for transactions, along with the Cuban peso (CUP). In 2003 and 2004, the government replaced the US dollar with the Cuban convertible peso (CUC) at an exchange rate of 1 CUC:1 USD. Today, the CUP and the CUC are both issued by the central bank.

The two-currency system is a serious drag on Cuba's financial structure. The relative prices in these currencies generally reflect a 24:1 exchange rate; retail markets can set prices in either. Workers in state-owned enterprises are paid in CUPs. Foreign-owned firms pay US dollars to a government employment agency that then pays those firms' workers in CUPs but at a rate less than 24:1.

Recently, in the Mariel special economic zone, workers' CUP wages have increased to 10 CUPs for each dollar paid to the government employment agency. Likewise, agricultural cooperatives that were selling to foreign-owned hotels had been paid 1 CUP for each dollar that the hotel paid to the state financial intermediary. Now these cooperatives are being paid 10 CUPs for each dollar.

The dual monetary system sets up perverse incentives; for example, firms can purchase foreign inputs with dollars bought at a favorable exchange rate, prompting an overreliance on imported goods. This mispricing leads to distorted decisions that do not reflect actual scarcity. The government recognizes that currency unification is inevitable, but it will present challenges, such as inflation and balance sheet mismatches.



The Banco Popular de Ahorro in Matanzas City, Cuba



# Financial and Monetary Reform: Five Pressing Priorities

**C**uba faces five main financial hurdles: liberalizing the financial system; unifying the dual currency system; boosting lending to small and medium-sized enterprises; providing greater financial services to its people; and becoming part of the international capital market. Meeting these challenges will stimulate the development of the Cuban financial system and improve the well-being of the Cuban people.

## 1. Financial Liberalization

Financial liberalization would mean that banks become more than just deposit institutions, as they largely are today. It would allow newly formed banks or branches and subsidiaries of foreign banks to serve as lending institutions that provide credit for the nascent entrepreneurial class. This could foster a dynamic private sector that creates jobs and offers goods and services to the Cuban people. An expansion of banking services would also include car loans and mortgages, which are currently unavailable, and expand lending for goods used for home improvements and big-ticket consumer items like refrigerators.

Financial liberalization also means that interest rates on both deposits and loans will reflect market factors and risk. Currently, the government sets interest rate ceilings on deposits at 8 percent and on borrowing at 9 percent to 15 percent, depending on the type of loan.<sup>2</sup> The supply of microfinance loans provided by banks (discussed below) would increase if borrowers paid higher interest rates, which could be warranted because of their riskiness and processing costs. At the same time, government bonds pay only 2.5 percent, which is a fiscal boon for the state. A liberalized

financial system would allow for the creation of an interbank market in government bonds, which would establish a bond price based on underlying economic fundamentals.

The process of moving from government-controlled banks and directed lending to a system that includes foreign private banks will present challenges. One risk is a period of euphoria followed by retrenchment, leading to a boom-bust cycle. Appropriate regulation and oversight of the financial sector are necessary to avoid this trap. But it is also important that the government neither overregulate and strangle the financial sector, nor succumb to the temptation to direct new banks to finance politically attractive but economically questionable projects.

## Recommendations



**Cuba:** Liberalizing rules for foreign financial institutions in Cuba can, if properly managed, jump-start financial liberalization in a way that does not threaten financial stability. Multibank, the third-largest Panamanian bank, has announced plans to open an office in Cuba to serve businesses and support the Cuban financial system.<sup>3</sup> The Cuban government should encourage similar deals.



**United States:** The Obama administration should remove barriers to the IDB providing assistance to Cuba. There are various avenues to do this, including a US abstention at an eventual IDB board of directors vote on whether to include Cuba, or by declaring IDB cooperation with Cuba

to be in US national interest. The second approach could constitute a back-door way to getting around the multiple laws prohibiting US support for financial institutions that engage with Cuba.

Such a move would enable the IDB, as well as the IMF, to provide much needed technical assistance—though the IDB would be more palatable politically for Cuba. Another option, which avoids any US legal ramifications, is for the respected regional development bank Corporación Andina de Fomento (CAF), of which the United States is not a member, to take the first step to oversee technical assistance to Cuba.

## 2. Monetary Unification and Reform

*Dia cero*, the promised day of currency unification, will inevitably come. Until then, the financial system remains segmented and the markets distorted, resulting in stunted economic growth and development.

The dual monetary system imposes enormous costs on the business sector. The CUP-USD exchange rate does not reflect the currencies' true relative prices. This price discrepancy distorts other relative prices, which reduces economic efficiency and the appropriate allocation of resources. In particular, Cuban exporters get one CUP for every US dollar they earn. While Cuban importers pay too little for dollars, and, therefore, for the foreign goods they purchase. Cuban enterprises can get CUP loans, but they can spend them only within the national economy.

This system also fuels perceptions of income inequality. Salaries in the least-productive areas of the economy are paid in CUPs. Meanwhile, salaries in the more dynamic sectors—such as tourism, foreign manufacturing, and infrastructure investment—are now paid in CUCs.

This has given rise to the flawed perception that monetary duality is the main cause of inequality. But inequality primarily stems from the fact that low state salaries reflect low

productivity, not because of the monetary unit in which the salaries are paid. Nonetheless, changes in relative prices in the wake of currency unification may adversely affect the poor and others who spend a higher proportion of their incomes on food and staples if the prices of these items rise disproportionately.

Currency unification will impact the Cuban monetary system in several ways. For one, the new Cuban currency will have a new dollar exchange rate. Monetary unification will include a devaluation from the 1:1 CUP-US dollar exchange rate since the new currency's value will be some average of that rate and the 24:1 CUP-USD one. The government's recent move to a 10:1 exchange rate for workers in the Mariel zone and for the sale of agricultural goods to foreign-owned hotels may indicate the exchange rate that the government is aiming for on *dia cero*.

As a result, banks and enterprises will face balance sheet effects reflecting mismatches between their assets and liabilities, arising from the rates at which CUCs and CUPs are converted into the new currency. In addition, the Cuban government has promised that currency unification will not affect the value of people's bank accounts, which could result in fiscal costs to bail out banks that face currency mismatches.

Currency unification can also serve as a positive incentive for foreign investors and the nascent private sector in Cuba. With the change, relative prices may finally reflect economic realities. Currency unification improves transparency, helps ensure economic decisions reflect relative scarcity, and promotes better measurement of economic outcomes.

### Recommendations



**Cuba:** Economic policy should not cancel the effects of devaluation, but it could be used to ease the transition by managing changes, especially to the most economically vulnerable. A successful transition requires clear

rules and direction for subsequent monetary policy. On the fiscal front, the government will need to come up with new sources of revenue to replace funds obtained through the presence of the dual currency system and the CUP:US dollar fixed exchange rate.

Monetization of the deficit—printing money to finance government expenditures, leading to inflation—has dropped dramatically, but it is still significant. According to the Ministry of Prices and Finance, almost a third of the fiscal deficit since 2014 has been financed by monetization.<sup>4</sup> The Central Bank of Cuba will need to be transparent in its goals, and independent in its decision making.



**United States:** Allowing the IDB and the IMF to provide technical assistance to Cuba would be especially helpful for this complicated policy initiative. This first international institution assistance in years would not be in the form of large loans, but rather discreet advisory technical assistance. Cuba could benefit from the advice of institutions that have helped with transitioning economies all over the world—Vietnam, Albania, and Myanmar are just a few examples.

### 3. Banking for Cuentapropistas: Small-Scale Lending and Microfinance

Small and medium-sized Cuban private enterprises, cuentapropistas, lack access to sufficient resources for continued growth and prosperity. The number of private businesses has tripled since President Raúl Castro came to power, and the number of nonagricultural cooperatives and individuals leasing land has also grown.<sup>5</sup> To continue this trajectory, these enterprises, individuals, and cooperatives need access to credit for investment and working capital.

Although microfinance lending has expanded, it has been quite limited. Official figures from the Central Bank of Cuba show that in the wake of the November 2011 government banking reform, 378,011 people received financing worth 3.2 billion

CUPs (\$135 million at the current exchange rate) between 2012 and 2014. This means the average loan was about \$360, an amount too small to finance a business. In fact, only 34 percent of lending went to individual farmers and small enterprises. Microenterprises accounted for only 2.6 percent of new loans. Almost two-thirds of this lending (63 percent) went to finance home construction and improvement, though some of this may represent microbusinesses, such as rooms for tourists.<sup>6</sup>

Microfinance has been available only through local banks, as opposed to international microfinance banks or nongovernmental organizations (NGOs), which has presented a number of obstacles to its development. From the perspective of the banks, microfinance is expensive; the small size of the loans prevents the realization of scale economies. Moreover, the creditworthiness of borrowers is hard to establish given the lack of financial history of most Cubans. Another impediment is the lack of familiarity with the use of credit among business owners and entrepreneurs, a result of decades of a fully state-owned and operated political and economic system.

### Recommendations



**Cuba:** The government should allow international microfinance banks and NGOs to provide microfinance. To date, the Cuban government has been reluctant to accept microfinance opportunities from abroad. The three state banks that are currently engaged in microfinance are not promoting partnerships with other stakeholders to expand microcredit.

International experience shows the necessity of strategic partnerships with municipal and provincial governments, regional enterprises, NGOs, and even universities and research centers that could activate microenterprise incubators. Local institutions act as guarantors, contribute to choosing the best projects, help identify local financial needs, and propose tailored microfinance services.



**United States:** The United States should liberalize the rules allowing banks and microfinance NGOs to operate in Cuba.

The Treasury Department stated in January 2015 that a limited range of US projects that support microfinancing in Cuba will be allowed, although no projects have yet emerged. A broader range of US banking services for Cubans are still prohibited. These prohibitions should also be eliminated, although the Cuban's government's willingness to allow the presence of US banks is uncertain.<sup>7</sup>

#### 4. Banking for *un Tipo Común y Corriente*: Services for Depositors

Another consequence of the small number of Cuban banks and limited access to technology is that Cubans do not benefit from banking services common in other countries. The number of bank branches per capita is not far from the average in Latin America, but Cuba greatly lags behind other Latin American countries in its number of automated teller machine (ATMs), with 7.3 per 100,000 adults in Cuba, as opposed to the regional average of 35.6 [see table 1]. To bring Cuba up to par would require a five-fold increase in the number of ATMs.

But this increase, even if possible in the near future, would likely not address deep regional disparities. Financial services are concentrated

in Havana and the country's provincial capitals. Access to banking services is limited and difficult in much of the rest of the country. Of the 498 ATMs in Cuba, 343 are in Havana. A similar disparity is found in debit cards. By the beginning of 2014, 1.2 million of the 1.6 million debit cards (75 percent) had been issued to residents of Havana, which has about 30 percent of the country's economically active population.<sup>8</sup>

One possible way to expand the provision of banking services is through mobile banking, which operates through cell phones and over the Internet. It requires much less infrastructure than other ways of providing these services (a feature that has proven very important in other developing countries). In Africa, for example, mobile banking has dramatically expanded with an increase in cell phone coverage. Versions of Kenya's M-Pesa system pioneered by the country's largest cell phone company, Safaricom, have spread throughout Africa. These mobile banking services allow people without access to credit or banks to make purchases and payments, deposit savings, and transfer funds. The transfer of funds may be especially important in Cuba since remittances from the diaspora, which have always been important, are likely to grow with the removal of US limits.

But expanding mobile banking requires greater cell phone and Internet coverage. Although growing, coverage in Cuba still lags behind countries at similar levels of development. The state company Empresa de Telecomunicaciones de Cuba (ETECSA) opened a number of areas for Wi-Fi connections in public places in 2015, but there are currently only thirty-five hotspots (with plans to open twenty more in 2016). The price of connection is very high at \$2 per hour.

**TABLE 1: BANKING SYSTEM STATISTICS, 2013**

	Bank branches per 100,000 adults	ATMs per 100,000 adults
Cuba	11.1	7.3
Brazil	47	128.8
Mexico	15	47.4
Dominican Republic	11.5	32.5
Latin America	28.4	59.2

Source: Central Bank of Cuba and International Monetary Fund.

## Recommendations



**Cuba:** The quickest way to jumpstart the provision of financial services is through mobile banking. For this reason (as well as others), the Cuban government needs to foster the expansion of Internet and cell phone services, as well as a wider use of information technology. In the short term, the capability to provide mobile banking may be beyond the capacity of Cuban banks. In addition, the Cuban government should permit more foreign bank branches.



**United States:** It is not the Cuban government alone that is keeping foreign bank branches from serving the Cuban people. The United States does not allow its private banks to provide financial services for Cubans in Cuba (as opposed to providing financial services for Cubans while they are in the United States, something that has recently become allowed). Banks in other countries also face possible US sanctions if they operate in Cuba.

The US government could facilitate the development of financial services in Cuba by removing its rules preventing banks from serving the Cuban people, and by making it clear that, with the elimination of these rules, foreign banks operating in Cuba will not be subject to US sanctions or fines. Finally, the United States could help the development of modern banking and mobile banking services in Cuba by allowing its companies to provide technology services, now prevented by the embargo.

## 5. International Integration

International financial integration could provide Cuba with resources from the world capital market to advance its development. The first key-step forward is membership in international financial institutions.<sup>9</sup> This would increase its capacity to attract foreign capital, reduce investor risk, support greater economic integration, and lower interest rates for international financing,

as well as afford the Cuban government access to international technical assistance and training. Others are already taking important steps toward Cuba's reintegration into the international financial community: Paris Club creditor nations recently forgave \$8.5 billion of Cuba's \$11.1 billion debt, with restructured payments on the remaining debt.<sup>10</sup>

Stronger representation of foreign banks and financial institutions on the island could establish another important link between the Cuban financial system and the world capital market. These foreign banks are unlikely to meet the needs of small lenders, but they may be able to provide loans for public-sector and public-private enterprises (such as tourism) that would be necessary for large-scale projects.

Currently, there are nine offices representing foreign banks and four representative offices of nonbanking financial institutions in Cuba.<sup>11</sup> These foreign financial institutions only have license to represent their bank in operations with the Cuban economy, which allows them to provide management advice and to promote and coordinate business between Cuban enterprises and those from other countries.<sup>12</sup> They do not have branches on the island nor do they operate directly with borrowers or lenders. Two Spanish banks are shareholders (together with Cuban state-owned commercial banks) in some nonbanking financial institutions.

Cuba's presence on the US State Department's list of State Sponsors of Terrorism had been an important impediment to its international financial integration. The country's presence on this list, as well as the regulations of the US embargo on Cuba, made it illegal for financial institutions to receive US dollars from the Cuban economy. The US government actively pursued banks that violated this prohibition, leveling fines of \$536 million on Credit Suisse in 2009 and \$8.9 billion (including violations against Iran and Sudan) on BNP Paribas in 2014 (BNP Paribas closed its branch in Cuba in February 2014).<sup>13</sup>

As recently as March 2015, the US Treasury Office of Foreign Asset Control (OFAC) announced a \$258.7 million settlement with Commerzbank AG that involved, in part, accusations the bank facilitated payments violating the Cuba sanctions.<sup>14</sup>

With the removal of Cuba from the State Sponsors of Terrorism list in April 2015, OFAC allowed US banks to open correspondent accounts in Cuban banks to facilitate payments and transactions with the United States. Multibank Panamá already had correspondent accounts with Cuban banks, bypassing US sanctions on the use of dollars by making transactions in the Panamanian balboa rather than in dollars.

In July 2015, Florida-based Stonegate bank (the bank for the Cuban Embassy) was the first, and is still the only, US bank to establish correspondent accounts with a Cuban bank, Banco Internacional de Comercio. This correspondent account enables Stonegate to offer a Cuba-specific debit card for US visitors to the island. MasterCard removed its network block on US-issued cards in March 2015. But banks remain reluctant to allow the credit cards they sponsor to be used in Cuba because there is no way to ensure that the use of these cards will not violate the embargo.<sup>15</sup>

In January 2016, the United States began to allow US depository institutions to provide

financing for authorized exports to Cuba (with the exception of agricultural commodities and items), including letters of credit. This easing of restrictions will help facilitate US exports to Cuba since letters of credit and other types of trade financing are vital for international transactions.<sup>16</sup>

## Recommendations



**Cuba:** The government should take steps to demonstrate its commitment to the country's international financial integration. One positive step would be to actively pursue membership in the IDB. The Cuban government also should show that it is really committed to giving up its near-monopoly position in banking by allowing foreign banks to establish a presence in Cuba.









**United States:** The United States could help its own companies by eliminating restrictions on financing trade with Cuba. More clarity on what is and is not allowed would also mitigate US financial institutions' fears of engaging with Cuba. The United States could help promote the provision of finance in Cuba by further easing restrictions on US accounts for Cuban nationals to enable them to use these accounts while in Cuba, not just while outside the island.

# Conclusions

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The Cuban government has a dominant role to play in determining the future landscape of the country's financial markets. This is a multifaceted issue. Finance operates in combination with a constellation of other factors, including sound laws, institutions that respect property rights, and confidence that rules will not be arbitrarily changed to suit government activities. In addition, Cuban finance can be brought into the modern era only if financial firms and banks have access to information technology and computing power.

## Recommendations for the Cuban Government

-  begin a gradual path of financial liberalization that includes appropriate oversight of financial institutions and the development of an interbank market in government securities;
-  open the door to foreign bank branching in Cuba to jumpstart the provision of finance;
-  set the stage for a successful move to *día cero*, when the currencies are unified, which includes determining and clearly signaling the unified exchange rate for the new currency;
-  allow international microfinance providers and NGOs to offer microfinance in Cuba;
-  foster the expansion of online banking services and mobile banking to improve retail banking and customer access to finance; and
-  integrate with the international financial system, with a good first step of seeking membership in international financial institutions.

President Obama will travel to Cuba on March 21st. With many of the diplomatic and political issues already resolved, financial matters could prove to be the leading edge of new cooperation between the two governments. While maneuvering space is limited by the congressionally-imposed embargo, the US Treasury could move more quickly and decisively to promote the financial and economic development of Cuba. The US Treasury has a very specific role to play in removing obstacles to the creation of a viable financial system that will improve the lives of Cubans and build on the many regulatory openings since December 2014.

## Specifically in terms of finance, the US government should

-  remove financing restrictions for agricultural commodities and items;
-  liberalize banking rules to allow accounts for Cuban nationals that can be used both when in Cuba and abroad;
-  move toward greater liberalization that would enable US banks to operate within Cuba;
-  allow the US dollar to be used for transactions with Cuba;
-  clearly signal to foreign banks that they will not be prosecuted for operating in Cuba;
-  and remove obstacles to Cuban accession to international financial institutions.

# Endnotes

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- <sup>4</sup> See “Cuba Respalda su Déficit Fiscal con Bonos Soberanos (+ Dictamen del Parlamento),” Cuba Debate, July 5, 2014, <http://www.cubadebate.cu/noticias/2014/07/05/cuba-respaldara-su-deficit-fiscal-con-bonos-soberanos-dictamen-del-parlamento/#.VmRn5I-cGUk>
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