

# Cuba: reforming the economy and opening society<sup>1</sup>

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## ■ Executive summary

Cuba is undertaking an internal and external adaptation process to ensure the survival of its economic and political model in a globalised world. In spite of the ongoing restrictions imposed on trade, investment and mobility by its most powerful neighbour, the U.S., Cuba has succeeded in forming new alliances with its regional neighbours that have shown an economic and/or political interest in the future of the current Cuban system. The effects of limited political reform and the limited lifting of communication and travel restrictions have increased relations with the Cuban community abroad. The success of economic reform measures depends not only on the still-missing internal consensus of a fairly divided Cuban society, but also on the external cooperation of both friends and foes in the international community. The reintegration efforts with the global North (the European Union and U.S.) seem to be one of the strategies for updating the island's economic model and contributing to a gradual reform of its political model.

## Introduction

Very few countries in the world have been so dependent for their development – or the lack of it – on external actors as Cuba. Since its revolution in 1959 the country has been suffering from the impact of international politics inspired by economic or geopolitical reasons. The development of its post-revolutionary society and the survival of its model have basically depended on the support of or its denial by the two cold war superpowers. At the same time the Cuban revolutionary regime has tried to project itself externally and to influence the international power balance by using quite unconventional measures. In the post-cold war period other external actors, principally Venezuela, but to some extent also China and Brazil, have been essential for the continuity of the Cuban model. Additionally the role of the Cuban diaspora cannot be overestimated, since about 15% of Cuba's population have left over the years because of lack of economic and political opportunities. Especially now, even 60 years after the revolution, remittances from abroad represent Cuba's most important source of income and constitute a crucial financial input in the recent establishment of non-state enterprises. In many respects Cuba already represents an example of a transnational society that is completely opposite to what the Cuban revolution with its strong nationalist flavour wanted to achieve.

The changes under way, called the “actualisation of the Cuban model”, are consequently determined principally by “intermestic” factors, i.e. a combination of external and internal interests, and the influences of various sectors of Cuban society and their foreign counterparts.

Already during the last decade the need to adapt the country's development model had become obvious to the Cuban government, and only the way in which changes are implemented and the extent of the reforms have been a matter of controversial internal discussions. The central problem facing the Cuban leadership is to what extent the Cuban revolutionary model can be adapted to the rapidly changing conditions of a globalised world in which it is not realistic to count on continuous subsidies from the diaspora or ideologically close allies. Up to this point the reform process seems to be based on a “trial-and-error” method with the clear intention of postponing all dramatic changes until after the retirement of the revolutionary political generation, which will likely occur in 2018. Undoubtedly the reforms currently under way have already produced some remarkable changes in the Cuban model and have strengthened the position of the president, Raúl Castro, who was elected by the Cuban National Assembly in February 2008, although internal disagreements among the party

<sup>1</sup> The findings of this report are based on interviews with government officials, academics and diplomats in Havana and experts on Cuba in various Latin American countries, and the available literature.

leadership between the reform and status-quo advocates are slowing down and complicating the process.

## Concepts and intentions of economic reforms

In April 2011 the Sixth Congress of the Communist Party of Cuba (PCC) in Havana published its famous guidelines (*Lineamientos de la política económica y social*), which were widely seen as an effort to modernise the Cuban economy and simultaneously improve the legitimacy of the Cuban government. Since then the major discussion has been between those who want to move quickly towards a mixed economy, with a strong emphasis on state capitalism, and those who fear the entire reform process and its possible outcomes. The obvious need for the opening up of major sectors of the Cuban economy to foreign investment and some sectors to the establishment of national private enterprises must be seen in the context of steadily declining productivity and a lack of sufficient public funds to maintain an incipient modernisation process. Only a modernised economy will permit the island's more productive integration into the changing world economy and reduce its vulnerability resulting from its reliance on external subsidies. Additionally the government had become well aware of the frustration of large parts of the population with declining living standards and reduced social benefits, while bureaucratisation and corruption were clearly on the rise. Implementing wide economic reforms without major political change seems therefore to be the overriding priority of the Cuban government, which is seeking to avoid resistance to the reform measures and thus help to ensure the legitimacy of the next government when the "revolutionary generation" leaves power in 2018.

The reform process has been described by Raúl Castro as one "without haste, but also without pause". Despite the preoccupation of the government with the speed of certain market-oriented reforms, no master plan seems to be in evidence, but the economic updating process is mainly concentrated on six goals:

- the reduction of state employment in many sectors;
- the expansion of proprietary rights;
- an increase in government income through taxation of the new self-employed;
- the attraction of foreign investment and technology;
- the strengthening of the currency by the convergence of the current two monetary systems (see below); and
- the general improvement of living conditions.

The announced massive reduction of state employment by about a million jobs seems to be falling behind schedule because of the slow implementation of the necessary administrative reforms and decentralisation processes. The extension of the non-state sector, where self-employment has been allowed for some years, is rather limited and has affected less than half a million people to date, mainly in the services sector and excluding health and education.

So far the most visible economic changes are linked to what the government considers to be the daily needs of the population. The prohibition on buying and selling private apartments or vehicles was lifted in 2012, while agricultural cooperatives were allowed to sell their products directly to consumers without the state as intermediary. Recently, the provision of public credit for the self-employed and cooperatives was introduced. Even though the self-employed have carved out a more independent life for themselves since 2010, their dependence on outside financing has become a problem and many of the new enterprises (about 60%) rely on finance from relatives or friends living abroad.

These remittances, mainly from the U.S., but also from Spain and other Latin American countries, constitute the largest source of income in Cuba, surpassing tourism and trade, and appear to be the major factor in the establishment of a market-oriented sector in the economy. Cuban society is now characterised by huge differences between those who have access to foreign currency – about 40% of the general population, but 60% of people living in Havana, according to current estimates – and those who cannot rely on the booming black market to fulfil their daily needs. The expectations of most Cubans for the adaptation and modernisation of the Cuban socioeconomic model are likely to be disappointed, since these expectations are widely based on the way of life of the diaspora in Miami, which has become more visible since 2013 after the travel ban was almost entirely lifted, with the sole exception of that on security and medical personnel.

From the government's point of view the pace of these reforms has to be sufficiently gradual to avoid the effect of the success of private enterprise on the political structure of the state, while at the same time it has to be sufficiently rapid to alleviate the current economic crisis and thereby improve governability. The question of how to deal politically with the new market-oriented economic actors was a preoccupation of the Sixth PCC Congress in 2011, and even more so at the First National Conference of the PCC held on January 28th and 29th 2012. It seems that the government tends to favour the cooperative format because of its collective nature. But so far it has quite openly tolerated the overwhelmingly private character of the self-employed sector of the economy and attempts to limit its members' private benefits only through regulation and taxation. It therefore seems to accept the risk that the success of the self-employed will result in increasing inequality in Cuban society. The government is well aware that the reform process has to be channelled through a filter of bureaucratic safeguards to prevent the transformation process from creating social conflict.

Resistance to change is not only ideological, but also a result of the obvious fear of a large proportion of the state bureaucracy that its members will lose the very limited benefits of their position because of the reforms. The main problem of updating the Cuban economic model is precisely

the excessive concentration of economic decision-making at the state level, as well as the necessary and inevitable reduction of public spending, which is seen by the reformers as the greatest challenge the process faces.

The essence of the reform of the economic model is the urgent issue of improving productivity. The chronic deficit in external trade has been a factor since the Cuban revolution and even now very few products are available for export: nickel, and some pharmaceutical and biotechnological products are the principal items. However, Cuba has been very innovative in the development of new lines of exports, basically of professional services, not only in the much acclaimed health sector, but also in terms of the secondment of social services professionals of various kinds, principally to Venezuela and other Bolivarian Alliance for the Americas countries, but recently even to Brazil.

To readdress the shortage of capital in a society that has traditionally spent all its income on public goods, the modernisation of the 1995 Foreign Investment Law in March 2014 has become the clearest expression by the Cuban government that it needs to accept capitalist incentives to attract more external financing. Foreign investment will now be welcome in all sectors of the economy except health, education, communications and security. The expectations are especially high with regard to a new development zone around Mariel port, to which Brazil has already committed almost \$1 billion in development funding. Another 23 projects have been undertaken by some European Union (EU) member states, China and Russia. The latter has positioned itself as a major Cuban economic partner by cancelling 90% of the island's \$35 billion debt to it and stretching the repayment of the remainder over ten years, with the intention of reinvesting the entire amount in the Cuban economy.

The idea behind the new development zone is to create a tax-free zone around the deepwater Mariel port for the production of a variety of products that will increase trade. The aim is to provide Post-Panamex container ships with a conveniently located, modern port for trade distribution across the entire Caribbean Basin after the opening of the modernised Panama Canal in 2015. The main criticism of this megaproject, which is being sold by the government as a magical solution to most of the structural and financial deficiencies of Cuba's current economic situation, is that such an enormous investment effort may come too late and will also have to compete with similar developments like the Colon Free Trade Zone in Panama. There is also the fear that much-needed foreign investment in the general infrastructure of the country will now be concentrated mainly in the new Mariel zone and be beneficial to foreign companies and the state, but not to the development of other non-state sectors across the country.

An additional obstacle is the implementation of the new investment strategy while all economic interactions between the U.S. and Cuban non-state enterprises remain completely illegal. Until this legal situation is resolved it

seems doubtful that foreign investment will arrive in such substantial amounts as to create the desired impact. The envisioned 30% annual increase in foreign direct investment – about \$2 billion – is considered by many Cuban economists to be unachievable, at least in the short term. As a result it appears to be extremely doubtful that the decentralisation initiatives and a bold change in the policy on property and business rights will be sufficient to guarantee that about 50% of the national economy will be in the hands of non-state actors by 2015, as foreseen by government guidelines.

The better functioning of the Cuban economy will depend to a large extent on the reform of the currency that was announced on March 4th 2014 by the Cuban government, but without reference to when it would actually be implemented. Since the withdrawal of the U.S. dollar from internal use in 2004 Cuba has experienced the parallel use of two currencies. This dual system of an internal Cuban peso (CUP) and a convertible peso (CUC) – with a relationship of 25 to 1 – makes it impossible to establish clear cost and benefit criteria, while simultaneously having very negative effects on the international competitiveness of the Cuban economy. In the short term the necessary currency reform will clearly create winners and losers in society, but over the medium term it should allow the Cuban economy to function better. Since Cuba is currently not a member of the various international financial organisations (IMF, World Bank, etc.) – but might consider rejoining them under certain circumstances – the government cannot ask them for assistance with the management of the unification of the dual-currency system, which might need a monetary reserve of about \$15 billion and carefully managed technical preparations to avoid any disruptions. The current relationship of the CUC to the CUP and the exchange rate with the U.S. dollar are the crucial indicators for the future development of Cuba's international competitiveness and will be decisive for the relationship between the state and non-state sectors of a new Cuban economy.

To what extent this economic reform process can be seen as preparation for a political transition in Cuba is widely discussed among Cubans themselves, as well as by the diaspora, the U.S., the EU and Latin American countries. The problem of restructuring an entire economic model usually results in a great deal of corruption. The Russian and Chinese examples are indicative of what Cubans might expect once the tight social control imposed since the revolution disappears. Even now most Cubans are aware of and disillusioned with the increasing breakdown of moral and civic values in a society that used to be proud of its commitment to (national/social) solidarity. Some are willing to accept that this is the price to be paid for the liberty to pursue their own interests, be they material or ideological, and to opt out of the collective system inherited from the revolution.

As other transitions from socialist systems have demonstrated – like those the countries of Eastern Europe

experienced after the collapse of the Soviet Union – this process often leads to the rapid disintegration of society, with the inevitable loss of a generation or a sector of society that identified – whether voluntarily or out of necessity – with the former socialist system. Thus it is quite understandable that a large part of the public administration now fears that it will lose its limited benefits, which are often related to state regulation of foreign trade, foreign investment and tourism. The obvious lack of interest in any type of far-reaching economic or even limited political reform is very visible in this part of Cuban society. The government seems to be aware of this and is trying to implement the necessary changes gradually so as to avoid protest from those parts of society that have thus far been most identified with the socialist system. Granting permission to the managers of state enterprises to play a larger role in the internal decision-making processes of these enterprises could therefore be seen as a possible extension of benefits to the state bureaucracy during the reform period, while simultaneously increasing the country's move to a more market-oriented economy.

### Slow motion towards political reform

The political dimensions of the adaptation process have already led to changes in Cuba's bureaucratic leadership. The new division of labour between the PCC leadership and the armed forces seems to consist of the party's efforts to limit the political reform process wherever possible, while the armed forces – with some support from academic economists – appear to be concentrating on the reform of the economy while occupying more and more key government positions. The armed forces are seen as leaders of the economic reform process because of their experience in managing some of the most successful state enterprises (they control more than half of them), while simultaneously being viewed as the most pragmatic part of the government.

Since the Sixth PCC Congress in 2011 the extent of political reforms has not been impressive. The logic of an authoritarian one-party state has not been challenged and the very weak, divided and strongly individualistic opposition groups still suffer from harassment by state organs or state-supported groups. The main focus of these dissident groups is the human rights situation in Cuba, which has been continuously criticised by the U.S. and some EU member states, where these groups' message is much more visible than on the island itself. Some support for opposition activities has always come from the Catholic Church, which has at times also functioned as a mediator between dissidents and the government, especially regarding the fate of political prisoners. The attempts of the current government to invite and allow more criticism has also impacted on the restricted communications scenario in Cuba. In spite of very limited individual access to the Internet, some new online publications could possibly help to overcome the typical problems of closed

societies (such as that of Cuba), where the voice of dissent is largely excluded from public discussions.

The liberalisation of travel and migration policies was probably the reform measure that was most welcomed by the Cuban population and the one with the most political, economic and social consequences. The massive increase in mobility not only between Cuba and the U.S. (because of the family bonds with Cuban-Americans), but also between the island and Latin America and Spain, has surpassed all government projections. The ability of Cubans to live and work abroad for up to two years will undoubtedly have an enormous impact on future perceptions in Cuba of the strengths and weaknesses of the island's society. The need to expand the political reform process is felt more strongly outside the party and government circles, but by no means only there. Many Cubans believe strongly that the modernisation of the economy and the opening up to outside influences and experiences will almost automatically lead to a more plural society and a political system in which the costs and benefits are divided up quite differently from at present.

### Reintegration into Latin America

The Community of Latin American and Caribbean States (CELAC) Summit in Havana in January 2014 was a clear demonstration that Cuba has once again become an important part of the Latin American community and that its policy of participating in all important regional discussions over the last decade and developing close bilateral relations with almost all the countries of the region has been very successful. Its presidency of CELAC has been praised for its careful balancing of diverging interests in the region and its efforts to participate in the creation of a regional voice without a marked ideological bias. But beyond its regional role, Cuba has also proved that it can contribute to the process of resolving long-standing regional problems. In the ongoing peace process between the Colombian government and the Revolutionary Armed Forces of Colombia guerrilla movement, Cuba's support was of outstanding importance for Colombia, in spite of the latter's very different relationship with the U.S., which is virtually the opposite of that of Cuba. Also, the peace process with the National Liberation Army (the other significant Colombian guerrilla group) or the resolution of the bilateral conflict between Colombia and Venezuela could not have taken place without Cuba's good offices. If the long-awaited peace agreement to end the longest internal conflict in Latin America can be reached, not only Colombia, but all Latin American countries will attempt to convince the U.S. that Cuba can no longer be called a state sponsor of terrorism. That fact that the U.S. still keeps Cuba on the list of sponsors of terrorism refers more to the sensitivity of any Cuban topic in U.S. domestic policy than to the country's foreign policy or national security considerations.

Since the last Americas Summit in Cartagena in 2012 Latin American efforts to integrate Cuba have been directed not

only at their own community, CELAC, but also to the wider hemispheric community. Latin American countries have therefore conditioned their attendance at the next Americas Summit in Panama in May 2015 on Cuba being invited. Cuba has been invited by the Panamanian government, but it is not clear if the U.S. will participate with Cuba present or will instead try to postpone the summit. This might produce a severe crisis for hemispheric relations. Not only has Brazil improved and extended its relations with Cuba, especially during the Lula da Silva presidency, and is one of the major investors in the island, but Mexico has also made enormous diplomatic efforts under President Nieto to overcome the period of poor relations and has announced its interest in becoming an important economic partner in the development of the Mariel port special zone. In that respect Cuba can now count on undivided diplomatic support and increasing investment from its Latin American partners.

But to what extent this might help to overcome the shock of a possible weakening of Cuba's special relationship with Venezuela is difficult to assess, since the entire reform process has already experienced increasing and unexpected stress and suffers from increasing concern over the island's vulnerability to external factors. Almost 40% of Cuba's trade is with Venezuela and the total yearly subsidies the island receives from that country are estimated at \$5-6 billion. In 2014 none of the foreseen subsidies, with the exception of the daily 98,000 barrels of oil, have arrived in Havana and so the entire state budget has to be rewritten for the second part of the year. A Venezuelan shock might therefore have similar, but by no means identical, consequences to the Soviet shock in 1991, when Cuba's economy contracted by about 35% and a so-called "special period" started that lasted until 1994, with serious cuts in social spending and severe suffering for the population. Cuban economists estimate now that "only" about 20% of gross national product depends on external subsidies, meaning that this time the shock will be not as severe as then, but could still imply another "special period" of about three years.

It is not only the economic fallout that Cuba has to fear from the instability of the *chavista* regime in Venezuela, but the political bond with that country will also have to be re-evaluated. There is a great deal of speculation outside Cuba as to what extent the Castro government might be willing to stabilise the embattled Maduro government in Venezuela with additional security personnel beyond the 500 military advisers that are currently in the country. A decision to beef up this force appears very unlikely to many Latin American observers, given the Cuban government's efforts to be seen as a constructive member of the international community. In Havana there is less expectation of the need for more Cubans to be sent to Venezuela than of preparing for the sudden return of about 40,000 Cuban health, social, sports and military personnel from that country. Given those lingering uncertainties about the *chavista* regime, in Havana a "plan B" (with "B" referring to Brazil) is often mentioned. However, in an election year in

Brazil, the politically dividing impact of the pro-Cuban politics of the Brazilian government has led to a reduced reliance on "plan B" in Cuba and to the favouring of a "plan C" (i.e. China). To what extent either one of these fallback plans is able to contribute to cushioning a possible Venezuelan shock will only become apparent over time.

## Reintegrating with the global North?

The reintegration of Cuba into the Latin American community and its successful presidency of CELAC (the EU's main regional partner) have given Cuba a new incentive to finally institutionalise its relations with the EU – Cuba is currently the only Latin American country without any kind of bilateral agreement with the EU. At the same time it is also the only Latin American country for which the EU established the 1996 "common position", which conditions formal relations on democratic political reforms and is therefore seen by Havana as a form of interference in its sovereign internal affairs. The common position came about after the shooting down of two small U.S. aircraft with four Cuban exiles on board by the Cuban armed forces. Before this incident the two sides had already held advanced discussions about a cooperation agreement. The reforms under way in Cuba have led to the February 10th 2014 EU decision to make a new effort to find a mutually acceptable agreement with Cuba that will facilitate trade and investment and institutionalise a dialogue on human rights. Visits by several foreign ministers of various EU member states have prepared the ground for the negotiations, which are now in their second round and are supposed to be leading to a so-called "Political Dialogue and Cooperation Agreement" by the end of 2015.

Havana is concerned that a problematic incident affecting the sensitive human rights issue could stall the negotiations once again. However, Cuba has been able to establish sound bilateral relations with many EU member states and has concluded bilateral cooperation agreements with 18 of them. The EU is economically quite important for Cuba, since it is the island's main foreign investor and its second-largest trading partner, while about one-third of all tourists come from EU member states. EU development cooperation with Cuba averages about €20 million per year and might increase once the intended agreement has been signed. The Cuban position with regard to the European intention to support market-oriented reforms and human rights with the agreement under negotiation has been very clear: change in Cuba will never come about through external pressure – a conviction that the government has consistently maintained in all its foreign policy positions. It appears, therefore, that for both sides an institutional cooperation agreement will not so much be about economic benefits, but rather political gains, given that the EU wants to advance its relations with Cuba before a possible lifting of the U.S. embargo and Cuba wants to demonstrate to the U.S. its diplomatic capacity to gain formal acceptance of its economic model and governmental structure, while the U.S. still insists on

regime change before establishing diplomatic relations. For this reason Cuba wants to demonstrate to the U.S. that in light of wide international recognition of its government, it is high time for Washington also to engage with Havana.

The relationship between the U.S. and Cuba has been called “traumatic” by both sides and carries a heavy historical baggage not only because of the way in which Cuba’s pre-revolutionary semi-colonial status linked the country to the U.S., but also because of the revolution itself, the U.S.-supported invasion attempt in 1961 and the missile crisis in 1962. Due to all these events and the influx into the U.S. of a large number of Cuban refugees since 1959, the island has become more a “domestic” than a foreign policy issue for the U.S. The trade embargo imposed in 1962 has been used by the Cuban government as the main reason for impeding economic development and has certainly also contributed to very difficult U.S. relations not only with some Latin American countries, but also with various EU countries. The clearly failed U.S. efforts over 50 years to change Cuba’s economic model and the country’s political regime has led to strong demands, even from within the U.S. itself, to change this policy. In 2009 the Obama administration eliminated some travel restrictions for Cuban-Americans and has also extended some travel possibilities for other U.S. citizens with the “people-to-people” concept, so that the number of U.S. visitors to Cuba has climbed to over 400,000 a year. It also lifted the cap on remittances for family members of the Cuban-American community and since then cash and gift transfers to Cuban families has cumulatively reached an estimated \$8.5 billion.

All recent U.S. polls are showing that these measures do not seem to be sufficient and that a large proportion of the U.S. population wants a major policy change towards Cuba. In 2014 two of those polls indicated that 56% of the U.S. population is in favour of dropping the embargo, while even 52% of Cuban-Americans in Florida, where they are mostly concentrated, share this view and 68% are in favour of the U.S. establishing diplomatic relations with Havana. In spite of the outspoken anti-Cuba position in the U.S. Congress, a major change in public opinion seems to be under way, which also reflects a generational change among the Cuban-American community. The recent letter to President Obama signed by 44 prominent politicians and business leaders demanding a policy change was only one of many expressions of a notable change of mood in public opinion in the U.S. with regard to its relations with Cuba.

The most effective plea for such change came from former secretary of state Hillary Clinton, who in her recent book, *Hard Choices*, criticises the inability of successive U.S. administrations to come to grips with changes in Cuba. The number of important visitors to Cuba since the beginning of 2014, among them the presidents of the American Chamber of Commerce and Google, might also be an indicator of a possible change of attitude from the U.S. To what extent the Obama administration will be able to

overcome the opposition in Congress to the overturning of the Helms-Burton Act is very doubtful, however, given the general unwillingness of the Republican-controlled Congress to cooperate with the president, especially in terms of the issues that are important to Republican voters, one of which has always been U.S. policy towards Cuba. Many analysts in Havana are convinced that for strictly domestic U.S. reasons that are less related to voter opinion and more to massive campaign financing to both Democrats and Republicans from Cuban-Americans, who are against any modification of current U.S. policy towards Cuba, it is very unlikely that a lifting of the U.S. embargo can be expected soon.

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