Is Cuba's Economic Reform Process Paralysed?

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CUBA'S ECONOMY IS CURRENTLY A blend of paradox, contradiction and surrealism. The leadership is engaged in an almost triumphalist rhetoric of economic success while the economy stagnates and the country's capital stock continues its tragic and steady deterioration. Foreign enterprise in joint-venture arrangements continues to enter the economy while, simultaneously, domestic micro-enterprises are being asphyxiated by hostile public policies. A veneer of technical modernisation is being implemented in the state sector, while the leadership remains obsessed with the past—not only the events of the revolution of the 1950s but also the wars of independence.

After 40 years of Castro's rule, ten years of "economic independence" from the former Soviet Union, and almost five years of ostensible economic reform, where is the Cuban economy now? And where will it be in the near future?

Cuba's economic reforms proceeded with vigour from mid-1993 to late 1995 but have been largely paralysed since early 1996. This reform process generated hopes both within and outside Cuba that it would lead toward an economic system that permitted a larger role for the market mechanism and for small and medium-scale private enterprise. Cuba's political leadership has continuously emphasised, however, that the objective of the reforms was to save and perfect "socialism" but not to generate any sort of "transition" to another economic or political system.

The initial economic reforms contributed to a brief recovery in 1995 and 1996. In turn, and largely as a result of the recovery, the leadership stopped the reform process on the grounds that further liberalising reforms were no longer necessary. This reform paralysis has been an important cause of the slowing of the recovery in 1997 and what now appears to be stagnation in 1998. It is possible, however, that the difficulties emerging in 1998 may provoke a renewal of reform measures later in 1999 or 2000. It is also possible that further reform measures are ruled out until President Fidel Castro and First Vice-President Raul Castro have departed from the scene. But ultimately, and in the longer term, the unworkability of the current system means that a major liberalisation of economic institutions and economic policies is required.

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The Context of Cuba's Economic Reforms

The origins of Cuba's economic crisis are by now well known. The most important was the decline in foreign-exchange earnings (and thus in the capacity to purchase imports)—by roughly 75% from 1990 to 1993—as a result of the ending of the hidden subsidisation by the former Soviet Union. Other factors also contributed to the crisis, however, including:

- the lack of significant diversification of exports since the 1950s;
- inflexibility and rigidity in the central-planning system;
- lack of access to international credit since Cuba declared a moratorium on debt repayment and servicing in 1986;
- continuing policy pathologies, such as the grossly overvalued peso;
- the continuing US embargo, hardened further by the Helms-Burton bill of 1996; and
- the loss of export markets in Eastern Europe due to Cuba's new geo-economic position.

The result was a foreign-exchange crisis that intensified up to 1994, and quickly became a multi-dimensional crisis. In terms of macroeconomic aggregates, there was an approximate 40% reduction in the level of per capita output, caused by shortages of imported inputs of all kinds. An energy crisis also developed, when petroleum imports shrank by 42%. Food imports shrank, imported agricultural inputs declined sharply, food production contracted, and nutrition levels declined markedly. In addition, there was a collapse of saving and investment levels, further underutilisation of the labour force, rising fiscal deficits, accelerated money creation, and intensified inflationary pressures.

These interlinked crises lowered Cubans' living standards severely. Food availability through the rationing system declined sharply, requiring people to purchase food on the black market at high prices or in the dollar stores. Indeed, the state system for agricultural production and food distribution seemed on the verge of collapse by 1994, incapable of successfully adjusting to the problems created by the lack of imported inputs for the sector.

When faced with situations of extreme personal emergency, people found it necessary to improvise. They started up micro-enterprises providing some sort of product or service to earn money in order to acquire food outside the rationing system. They resorted to food purchase through illegal black markets. They increasingly held US dollars, as the purchasing power of the Cuban peso was declining rapidly because of the monetary financing of a growing budget deficit. The inflationary pressure from the excess purchasing power led to an increase in the price of the US dollar, which reached a brief high of about 150 pesos in the summer of 1994 (though officially the peso was at par with the dollar). It also drove up the price of black market foodstuffs and all other goods and services provided outside the state system.

The intensifying hunger for US dollars from 1990 to 1994 led to a variety of phenomena, all of which were quickly apparent to any visitor to Cuba. Cigars and rum, either stolen or of dubious source, as well as the services of prostitutes, were readily exchanged for dollars. Anyone with a car—doctors, engineers, retired army officers, teachers—could earn dollars by providing a private taxi service. Private eating facilities and private rooms made available for rent were manifestations of the intense need for US dollars, especially for the purchase of food.

The Reform Process

A series of economic reforms were introduced in Cuba beginning in the summer of 1993, after more traditional economic medicines such as the Food Program and the Rectification Program failed to have sustainable positive effects. The reforms decriminalised what people were already doing as part of their individual or family survival strategies. The first reforms legalised the holding of the US dollar, increased the amount of remittances which relatives abroad were able to send to family members in Cuba, legalised self-employment or micro-enterprises in a variety of areas, permitted the establishment of agricultural markets for the sale of some food products, and legalised industrial, artisanal, and transport markets.

The legalisation of self-employment activities in September 1993 (including 184 activities by early 1997) permitted an explosion of entrepreneurial creativity and the surfacing of many underground activities despite a range of restrictive regulations. Of particular importance, prices at micro-enterprises were to be determined by the buyer and the seller—that is, the price mechanism was permitted to operate. In June 1995, food vending in the street and at home, and the establishment of *paladares* (private restaurants) were legalised. The re-establishment of agricultural markets in September 1994 was an important step in the liberalisation process. All varieties of agricultural enterprise were permitted to participate, including state farms, the military farms, the *Unidades Basicas de Producción Cooperativa (UBPCs)* or quasi-cooperatives, private farmers, and small plot holders in urban or rural areas. This measure quickly generated positive results, such as increased food supplies in urban areas, reduced food prices relative to those prevailing in the black market, a reduction of the role of the black market, establishment of an integrated national market for foodstuffs, and greater incentives for food producers to expand supplies. Markets for industrial and artisan products were legalised in October 1994. This legislation permitted state enterprises, local enterprises, enterprises of the Ministry of the Interior, and own-account producers to rent space in designated market, areas for sales of their products. In these markets, prices were to be determined by market forces rather than by state central planners.

The micro-enterprise sector and the various market systems that were established between 1993 and 1995 expanded quickly and made valuable contributions to peoples' living standards. Its expansion generated significant employment, roughly 8% of the total. The sector generated relatively high incomes, due to the general scarcity of goods and services together with the excess purchasing power and money creation of the 1993-1996 period. However, there was undoubtedly a wide range of incomes earned within the sector. The micro-enterprises provided a broad range of goods and services for Cuban citizens openly and at prices determined by market forces. They provided things needed by the population for their everyday existence and which were not being supplied by the state sector. The proportion of domestic value added was generally high, as most inputs were relatively simple things that were available locally. Although they faced a variety of obstacles, the entrepreneurs in the sector demonstrated a surprising ability to invest, expand and improve their enterprises in the short period of time in which they operated in a reasonable business environment.

The "hard liners" viewed such reforms as, at best, necessary evils, introduced only under the duress of the crisis.

There were also some negative aspects to the functioning of the micro-enterprise sector which have received much attention within Cuba. Two, in particular, deserve mention. First, the income disparities within the sector were viewed as undesirable. Second, some inputs were apparently acquired through illegal channels, in the absence of other alternatives. These two aspects were used to justify the imposition of the tax system discussed below. Taxation of the sector is of course necessary. However, the high incomes in some areas of the sector could be dealt with by permitting unrestricted entry to new micro-enterprises, which would lower prices and incomes. There also is no doubt that some inputs were acquired illegally, but this was largely due to the state's requirement that all inputs be purchased from the dollar stores, from the agricultural markets, or from state monopoly sellers at very high prices (and often in dollars).

A variety of other reforms were enacted in this period. An important measure, adopted in late 1993, was the reinvigoration of small-holder farming in tobacco, coffee and cocoa with the distribution of land tenancy or *usufruct* rights to over 17,000 farm families. In addition, over 43,000 farm families were granted private use (though not ownership) of areas of about one-half acre each for cultivation of family food supplies. Furthermore, there was a reorganisation of non-sugar cane state farms and sugar cultivation-milling complexes in smaller quasi-co-operative enterprises (the *UBPC*s.) Though they are called "co-operatives", these farms are not yet true co-operatives because their cultivation mix, output prices, input prices and mix are still controlled by the state, although production above quotas is available for members' consumption or sale in the new farmers' markets.

A new law in 1995 regarding foreign investment liberalised the conditions under which foreign enterprises could enter into partnerships with Cuban state enterprises. Under this legislation, some 317 joint enterprises have been established, with 63 dissolved for various reasons. These partnerships have played vital roles in the expansion of tourism, nickel production, oil extraction, and some food processing (mainly for the tourist and domestic dollar market). Indeed, enterprises in these sectors have been the star performers in the economic recovery thus far. A new mining bill in 1994 liberalised the granting of mineral exploration concessions to foreign mining enterprises. Legislation in 1996 permitted export-processing zones in which duty-free imported inputs could be used for the fabrication, processing, and packaging of products intended for tourist and dollar stores or for export.

Fiscal policy has focused on arresting the (suppressed) near-hyperinflation of 1991-1993 by raising taxes and reducing subsidies to state enterprises in order to reduce the fiscal deficit, which peaked at just over 30% of GDP in 1993, thereby reducing the increase of the money supply and the extreme inflationary pressures this was generating. These measures have been quite successful. Further measures modified the organisation of the state sector and implemented reforms in the banking system. Other policy modifications have created tax regimes for microenterprises and have defined systems of fines and punishments aimed at microenterprise infractions of their regulatory regime.

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Will the Cuban reforms endure?

Is the Reform Process Over?

There are conflicting views concerning the future of Cuba's economic reform process. Those analysts who identify this process with an expanding role for market forces, for decentralised private and/or co-operative entrepreneurship and for a liberalised economic environment, generally concluded in early 1998 that the process was in paralysis and arguably in reversal. This view was echoed by the "hard liners" who considered such reforms as, at best, necessary evils, introduced only under the duress of the crisis and to be reconsidered when the situation permitted. Other analysts and officials argue that further policy and institutional changes, some involving further liberalisation measures, will continue. The strongest and most convincing exponent of the view that the reform process will continue is José Luis Rodriguez, Minister of Economy and Planning, who said "the economic reforms that we have been undertaking will have continuity." However, he mentions no new liberalising reforms.

The evidence supporting the view that significant liberalising reforms are not likely to occur in the near future include the *Economic Resolution* of the Fifth Party Congress, statements of the Revolutionary leadership, the general political environment, and recent policy measures which curtail the functioning, size and scope of the micro-enterprise sector. The general political environment in which the existing micro-enterprise sector operates has been hostile since early 1996. Indeed, in a major speech in April 1996, President Castro was critical of all reforms implemented since 1993, stating that the reforms were an unfortunate and negative phenomena which were adopted by necessity. This statement suggests that the continued existence of the reforms is by no means assured. In another marathon speech in June 1998, Castro again attacked "intermediaries" in the agricultural sector—an old obsession for him. In the view of some Cubans, this hard-line speech could signal a renewed attack on such "middlemen" without which the market system could not function with any effectiveness or efficiency. Public policy toward the micro-enterprise sector also appears to be designed to contain and reduce it—many analysts and micro-entrepreneurs would say "strangle" it. The sector operates within a highly restrictive framework designed to keep the enterprises very small, operating only in limited areas, generating low incomes, and not competing seriously with the state sector. One result is that many such enterprises are also condemned to low productivity and all the waste of human, natural and capital resources that this implies.

Among the legal restrictions on micro enterprises are:

- a prohibition of self-employment in professional areas;
- a prohibition from hiring labour (in practice, often beyond family labour);
- restrictions on access to markets, with prohibitions of sales to the state sector (with some exceptions);
- no access to credit, foreign exchange, or imported inputs;
- a prohibition of any intermediation (producers must sell their own output, and sellers must produce their own output);
- a prohibition on marketing through any public media; and
- specific limitations on private restaurants: a 12-seat maximum size, prohibitions from selling beef and seafood, confinement of input purchase to dollar stores and agricultural markets.

To enforce these and other restrictions, a small army of inspectors is empowered to punish infractions by shutting down enterprises immediately or by imposing fines of up to 2,400 pesos. (Note that the average monthly salary in 1997 was 214 pesos.)

The sector also faces onerous taxes. First, the tax is levied on 90% of *gross* revenues, and not on *net* revenues after the deduction of legitimate input costs. Second, the state determines the minimum amount of total revenues for many activities, this serving then as the tax base. Third, the National Tax Office requires that the tax payers pay any assessed tax shortfall if their monthly payments are less than the amount due, but does not compensate the taxpayer if an overpayment of taxes on the monthly instalments has occurred. Finally, the tax is regressive as it imposes a lump-sum tax at the beginning of each month.

The government has also established a new system of state food stores located both within and beside the private agricultural markets. These state food stores sell foodstuffs at lower prices than the private markets—which is possible because the state also sets the prices at which it buys foodstuffs from the state and the quasi-state sectors of agriculture. Many Cubans argue that the purpose of these state stores is to force the private agricultural markets out of existence.

The result of these policies was that the number of registered micro-enterprises declined from a peak of over 208,000 in March 1996 to under 172,000 in February 1997 and to under 167,000 by January 1998. Such enterprises have either closed or have retreated to the underground economy.

Economic Performance 1994-96: Reactivation

The reform measures of 1993-1995 were reasonably successful in helping to arrest Cuba's economic free-fall from 1986 to 1993 and in generating a reactivation from 1994 to 1996 (when per capita GDP increased by about 10%). However, the reactivation then decelerated in 1997, and the prospects for 1998 appear to be for stagnation.

The reactivation of 1994-96 was due to a number of factors. The most important are increased foreign and domestic investment in key foreign-exchange-earning sectors, increased remittances from family members residing outside of Cuba, and the liberalisation of agricultural markets and self-employment. Tourism capacity increased due both to major investments from eight foreign countries and to a relatively high level of domestic investment. This permitted a 46% increase in tourist arrivals and an increase in gross tourism receipts of over 62%. Nickel exports almost tripled from 1993 to 1996. Domestic oil production rose by 36% from 1993 to 1995. Exports of tobacco, seafood, and citrus products also recovered well.

Remittances from family members abroad has become the chief source of foreign exchange.

Remittances from family members abroad rose after 1993, reaching approximately US$ 800 million in 1996, or about 41% of merchandise exports. This indeed has become the chief source of foreign exchange for Cuba and the government, which has constructed elaborate state retail and food vending networks to recapture the foreign exchange as quickly and completely as possible.

Exports of goods and services, together with remittances, doubled between 1993 and 1996. This increase in foreign-exchange inflows, in turn, permitted an 88% increase in total imports. Higher imports of fuels and intermediate products then eased the supply side compression, permitting increased production in most other sectors. This general recuperation included fuel availability, electrical supply, the output of some manufactures, transport, and construction. It also led to substantial increases in tax revenues after 1993 that enabled the arrest of the ballooning fiscal deficits (which were feeding the hyperinflation).

The liberalisation of the agricultural marketing system, as described above, also had a positive effect on food availability and nutrition, thus improving Cubans' standard of living. The nutritional benefits from this liberalisation have been striking.

Economic Performance 1997-98: Stagnation

The macroeconomic slowdown of 1997 and 1998 resulted from a combination of circumstances. Of particular importance has been a tightening of the foreign-exchange constraint, due mainly to weak export performance, the lack of access to credit (due to the continued debt crisis), a growing outflow of interest and profit payments, and reduced effectiveness in the utilisation of the foreign exchange actually available. The lack of movement with respect to economic liberalisation measures and indeed the gradual stifling of the small domestic market economy as discussed above are also significant.

Weak performance in the sugar sector has been the major negative influence on foreign-exchange earnings. Part of the difficulty has arisen because of lower sugar prices in the international market in 1997 and in 1998. But low sugar harvests, despite major efforts at recuperation, are the central factor. Indeed, the 1998 harvest of 3.2 million tons (relative to harvests of 7 to 8 million tons in the 1980s) and an expected similar harvest for 1999 are the major negative features in the macroeconomic picture for 1998 and 1999. The problems of the sugar sector are the result of three general factors. First, while the sector is a major earner of foreign exchange, it is effectively starved of imported inputs for its own functioning. It has been a foreign-exchange cash cow that has been relentlessly milked, with insufficient attention to reinvestment, input-provision, and sustainability. Second, the incentive structure eliciting human energies in the sector has been problematic. By 1997, the bonus payment certificates paid to sugar workers permitting them to purchase scarce products in special stores no longer provided much incentive to work because the Sugar Ministry had insufficient foreign exchange available to purchase imported goods to stock the stores. Moreover, cane farmers or farm co-op members who had the opportunity to grow food for sale either in the agricultural markets or in the black markets were rewarded with much higher real incomes. In consequence, farmers' energies are often directed to their own private activities at the expense of state-run cane cultivation and harvesting. Third, cane planting and harvesting were "out of synch" from 1990 to 1997, with excessive amounts of immature cane being harvested prematurely in desperate attempts to raise the volume of the harvest. As a result, cane supply shortages were continuously shifted into the future, intensifying the impact of the shortage in each successive year. For the 1998 harvest it was decided that this unsustainable practice had to stop.

Three additional factors are relevant in explaining the scarcity of hard-currency earnings. First, the payments for profit repatriation and interest on short-term debt have reached high levels, around US$550 million per year, or over 28% of merchandise exports. These remittances will continue to be high in the near future. Indeed, Cuba may now have entered the classical situation in which annual profit repatriation by foreign enterprises exceeds the inflow of foreign direct investment so that the net contribution of the foreign-owned sector to foreign exchange availability is negative. Second, the debt-repayment moratorium declared by Cuba in 1986 limits access to foreign credit and necessitates the payment of high interest rates for the credit which it does receive. Without a resolution of the debt problem with the relevant Paris Club of creditors, Cuba continues to face difficulties in obtaining international credit. The US embargo and the Helms-Burton bill are not the problem—Cuba can and must resolve this problem itself. The third general problem is that the foreign-exchange earnings that have been generated from exports appear to have been used ineffectively. From 1996 to 1997, for example, the value of imports increased by about 13% but this was accompanied by a rate of economic growth of only 2%. Apparently, large volumes of imports did little to increase investment or to permit the increased purchase of imported inputs so as to relieve this supply-side constraint on production.

The positive aspects of the foreign-exchange prospects for 1998—especially the buoyant tourism and tobacco sectors, the latter with high prices and large production increases—are unlikely to outweigh the negative factors in 1998 and 1999. The weakness of the economy during the 1990s and its inability to diversify its range of exports are the result of the continuation of the policy pathologies and institutional rigidities discussed briefly below. Without changes in the exchange-rate system and without a major liberalisation of small- and medium-scale enterprise, it is doubtful that the restructuring of incentives and the massive investment required to revive, diversify and expand productive capacities can be achieved in order to permit Cuba to escape the vicious circles in which it is currently ensnared.

Continuing Challenges

During these latter years of the 1990s, Cuba has confronted a number of general economic problems, ranging from policy pathologies to institutional problems. A few of the more important of these are outlined in this section.

Investment

Cuba has a long way to go before it recovers to the levels of economic activity experienced in the 1980s. In terms of GDP, the economy has recovered to just under three-quarters of the 1985 level. However, because the GDP measure does not include depreciation, the official estimates of GDP growth for the 1990s overstate authentic macroeconomic performance. In other words, much of the reported GDP growth comes at the expense of allowing the capital stock to depreciate so that, in the absence of a significant increase in investment, similar growth in the future will not be possible. Depreciation of Cuba's capital stock has been high in the 1990s due to a sharp decline in investment from 1989 to 1994; the shut-down of a large proportion of the capital stock in manufacturing; and the cannibalisation of some machinery and equipment in order to economise on the acquisition of replacement parts.

Cuba faces a major task of refurbishing almost its entire capital stock.

In view of this collapse of investment, Cuba's economy is operating on an unsustainable basis, and thus Cuba faces a major task in refurbishing almost its entire capital stock. The casual observer in Cuba can see the immensity of this task. Major renovation and reconstruction are needed for public buildings such as schools, universities, and offices; streets, sidewalks, roads, highways and traffic-control systems; sewage and water systems; the electrical and telecommunications systems; the railroad system and even the hospitals. Housing, and especially housing maintenance, has been de-emphasised in some urban areas for almost 40 years, not just the decade of the 1990s. The stock of road transport vehicles is old, inefficient, energy-intensive, and highly polluting. The capital stock in industry, agriculture, and construction also requires immense investment. Indeed, the capital stock acquired between 1960 and 1990 from the Soviet Union and Eastern Europe is generally inefficient, environmentally unfriendly, and produces goods or services which are not internationally competitive. This capital will all have to be replaced, and soon. Perhaps the only areas where the capital stock has been replaced and extended is in tourism, including hotels and related service activities together with Cuba's major tourist site, Old Havana.

While major disinvestment continues, it is difficult to be enthusiastic about claims that the Cuban economy is on the road to recovery. The 1996 level of investment was not close to the level required to make output in that year sustainable. In the absence of new investment, the prospects for the Cuban economy are bleak indeed.

Incentives

One of the most serious problems facing the Cuban economy in the 1990s is its monetary, institutional and structural dualism. Because of the wide gap between the socialist "old peso" economy and the internationalised market-oriented and dollar-based economy, the general structure of incentives shaping people's economic energies has become deformed. People are desperate to earn dollars or to obtain them through every conceivable form of "rent-seeking". There is thus a powerful force impelling human and other resources to leave the socialist old peso economy and move to the internationalised dollar economy. For example, doctors drive taxis, self-employed scientists make footwear and run private restaurants, professors work in tourism—all examples of the exodus of people from the old peso economy to the dollar economy. The result is that the old peso economy suffers.

The response of the government to this economic duality has not been to merge the two parts of the economy by means of fundamental policy reforms, especially exchange-rate policy, but instead to restrict and heavily tax the market-oriented private sector. But this heavy burden of taxation does not get at the root of the problem.

Institutional Structures

To many observers, Cuba's economic institutional structure appears to be unsustainable in the longer term. In the words of the UN Economic Commission for Latin America and the Caribbean: "Like other socialist economies of Eastern Europe, the Cuban development model was already becoming inoperative prior to the 1989 collapse." The basic objective of the Cuban government, however, is to maintain socialism as it is understood in Cuba—the public ownership of almost all of the means of production and the maintenance of a centralised economic planning system.

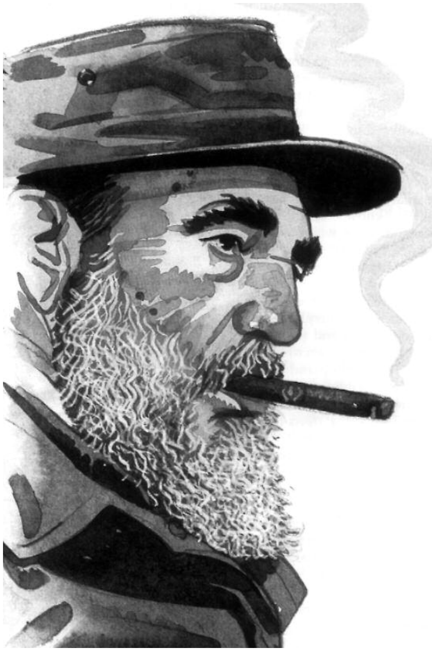
The weaknesses of central planning have made the economy inefficient, inflexible, and resistant to change. It is unable to adjust quickly to changing circumstances, to innovate and to diversify exports in the competitive international system. These weaknesses include the absence of a broad range of small and medium-size enterprises—a weakness Cuba is now trying to remedy, but within the state sector. The bureaucratised allocation of resources and the near absence of markets in the old peso core of the economy are problematic. The structure of incentives for managers in that part of the economy is also dysfunctional—managers are supposed to be order-taking bureaucrats rather than innovative risk-taking entrepreneurs.

Some efforts are being made to modernise and decentralise the economic planning system. The current vision involves the state maintaining a central overseeing and guidance role in the economy but placing greater reliance on local government levels and state enterprises that are endowed with greater autonomy in decision-making and are required to achieve financial self-reliance. However, in view of the disappointing results of earlier attempts to improve the functioning of the planning system there can be little confidence that Cuba will be able to make the old system work more effectively.

Exchange-Rate Policy

Perhaps the most serious policy problem confronting Cuba in the 1990s is its exchange-rate policy. The official value of the peso has been fixed at par with the US dollar, regardless of the underlying balance of payments situation, regardless of genuine domestic inflation rates relative to international rates, and regardless of the exchange rate of the US dollar in relation to all other currencies. (From mid-1997 to mid-1998, the Cuban peso actually *appreciated* by about 10% against the currencies of its trading partners because of the US dollar's strength during that period.) Parity with the US dollar constitutes an extreme overvaluation of the peso in terms of the underlying Cuban and international prices. Such a currency overvaluation is damaging to the Cuban economy for several reasons.

First, with the huge excess demand for imports over exports at the official exchange rate, a bureaucratic system of control over imports is needed. As a result, although tariff levels may be low, other restrictions on imports are often infinitely high, because what is not specifically permitted by government officials is prohibited (although some state conglomerate firms have some independent rights to importation.)



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A second consequence is that with permitted imports (at the parity exchange rate and in the peso economy) being artificially and extremely cheap, they possess a large cost advantage within Cuba over domestically produced products. This operates as a disincentive to the development of substitute products or to a natural process of import substitution. It should be emphasised that this is only applicable for the products where imports are permitted. For the prohibited products, protectionism is very high if not infinite, as noted above.

Third, the exchange-rate policy has helped block expansion and diversification of exports and increases in foreign-exchange earnings. In the last four decades, one of the greatest weaknesses of Cuban economic performance has been the failure to diversify and expand exports. Indeed, the pattern of Cuba's exports has not changed much since 1957. The traditional export products—sugar, nickel concentrates, and tobacco—continued to predominate into the late 1990s, although the very low sugar harvests in 1994-1996 led to a decline in its relative importance.

To conclude, extreme overvaluation of the peso blocks an expansion and diversification of exports, blocks a normal and rational process of import substitution, and requires intense forms of bureaucratic protectionism to keep out the huge volume of imports which would be demanded at the current official exchange rate. Changing the exchange-rate regime now, although probably unavoidable ultimately, will be difficult and will have to be carried out with caution.

Conclusion

The task of building the foundation for a sustainable economic recovery in Cuba is daunting. This will require a Herculean investment effort that will have to be financed mainly, though not exclusively, from domestic efforts. But the crucial factor that will determine the future pace of economic recuperation is the volume of export earnings which, in turn, is a central determinant of investment levels. In order to expand and diversify exports, a change in the exchange-rate policy is imperative, as also is a change in the character of enterprise. A change in the exchange-rate regime may be the most urgent and problematic policy change, requiring a wide range of other policy accommodations. The liberalisation of small and medium-scale enterprise liberalisation is unavoidable and must be achieved if human energies are to be used effectively and if a reasonable structure of incentives is to lead to socially desirable economic diversification.

In the short term, which may be as long as five years, it is unlikely that the reform process will be resumed unless the economic downswing of 1997-1998 is deep and continues for some years. It is clear that, barring such an eventuality, President Castro and the Communist Party of Cuba are determined to avoid any further liberalising reforms. In the long term, the limitations of central planning, the absence of dynamic small and medium-size enterprises, the disadvantages of continued policy pathologies, and the imperatives of achieving high rates of export expansion, economic growth and investment will ultimately lead to appropriate policy and institutional changes. ◆