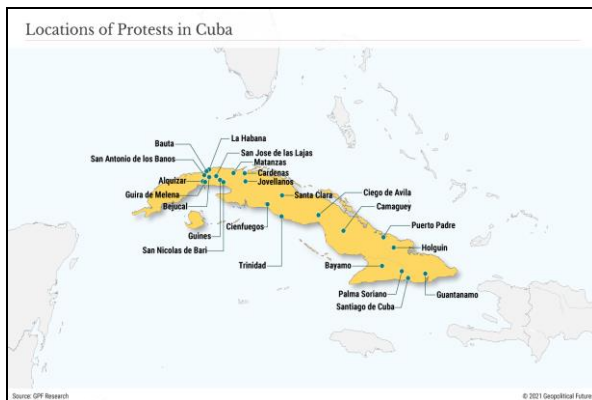


July 26, 2021

## The Protests in Cuba

Over the past two weeks, Cuba has been racked with widespread protests. As this map suggests, the civil unrest was scattered across the island nation.



(Source: [Geopolitical Futures](#); used with permission)

The widespread nature of the protests suggests some degree of coordination (and, it appears there was). Two groups, the [San Isidro Movement](#) and the 27N Movement, used social media to organize marches and protests. At the same time, [the size of the protests](#) also suggests widespread [dissatisfaction with the regime](#). Even the [elderly turned out](#). The regime blamed outside forces (read: U.S.), but this uprising seems to be [a home-grown response](#) to a deteriorating economy.

The government's response was typical. It arrested hundreds, [shut down the internet](#) on July 11, and promised to do better. After switching the internet back on a few days later, the world got a [peek at the repression of the Cuban security forces](#).

Cuba has geopolitical significance.<sup>1</sup> For the U.S., the risk of a foreign power controlling Cuba means that trade could be stifled at the Port of New Orleans, which is where the agricultural and industrial abundance of the Mississippi River system finds its way to the world. In addition, it could bottle up the Port of Houston which is critical for the American oil industry. Thus, the U.S. has been interested in Cuba since the Louisiana Purchase.

In this report, we will begin by discussing the underlying structural problems of the Cuban political system and its economy. Next, we will examine the specific factors that have negatively affected the Cuban economy and created conditions that have led to the current unrest. We will close with the U.S. response to the protests and market ramifications.

## The Problem with Leninists

Marx left his followers with a problem. On the one hand, Marx postulated that capitalism, due to its internal contradictions, would eventually fail and the triumph of communism was inevitable. If that position is accepted, there is little for a communist to do but wait. However, because life is finite on this earth, the Marxist is tempted to try to bring utopia to the world now. Lenin created the “vanguard of the proletariat,” a committed group of revolutionaries that would bring about communism to save the unenlightened labor class from oppression by capitalists.

<sup>1</sup> For a review of Cuban geopolitics and history, see our *WGR* from 1/5/2015, “[The Cuban Thaw](#).”

Unfortunately, in practice, the vanguard of the proletariat has never been able to bring the communist ideal to fruition. And, also in practice, much like the pigs in [Animal Farm](#), the communist parties eventually govern like a ruling class.

Revolutionary succession has been a persistent problem in communist states. The initial revolutionaries usually succeed because the revolution replaces a disliked, corrupt, and ineffectual regime. These revolutionaries have credibility as liberators. However, they don't live forever, and as the regime continues, the ties to past revolutionary glory fade. In the Soviet Union, the leadership became steadily older and increasingly ineffective, eventually failing. In China, Deng Xiaoping attempted to create an institutionalized succession; it worked until Xi Jinping took power. In North Korea, the Kim family relied on dynastic succession. And, in Cuba, the Castros simply stayed in power. Fidel ran Cuba from 1959 until 2008. Although he gave up formal positions of power, he maintained his influence through his brother Raul until Fidel's death in 2016. Raul has been giving up formal power since 2018.<sup>2</sup> The current leader, Miguel Diaz-Canel, became president in 2019, and, more importantly, became First Secretary of the Communist Party in April of this year. It is party control that is the true seat of power in communist regimes. At this point Diaz-Canel has complete formal control.

Communist economies tend to underperform capitalist ones, although during periods of industrialization, communist economic growth can be impressive. This is most likely because the party can direct investment more efficiently in the early stages of development. So, both in the

<sup>2</sup> See our *WGR* from 4/4/2018, "[Generational Change in Cuba?](#)"

Soviet Union and China, there have been periods of impressive growth. Where problems arise is once a certain level of development is reached, financial markets tend to do a better job of allocating investment compared to government mandates. In the Soviet Union, growth stagnated in the 1970s and the U.S.S.R. steadily fell behind the West. China may be at that stage now.

The smaller communist states, on the other hand, didn't achieve industrialization. The North Korean and Cuban economies were heavily dependent on subsidies from the U.S.S.R. When the Soviet Union collapsed in 1990, the economies of North Korea and Cuba suffered greatly. Despite widespread expectations of collapse, both regimes managed to maintain power; North Korea did so by hailing the Kim dynasty and Castro through revolutionary credibility.

However, Cuba is now being run by a leader who is not a Castro and has no ties to the original revolution. Cubans seemed more willing to give the Castros the benefit of the doubt when the economy slumped.<sup>3</sup>

### The Current Problem

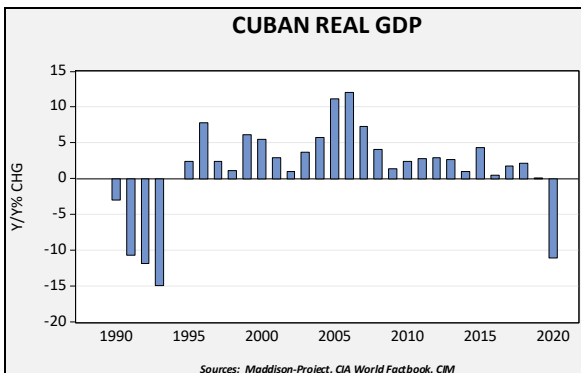
Since the communist revolution in Cuba, the country has struggled with weak productivity. For example, despite some of the richest soil in the tropical world, Cuba's [corn production per acre is around 39 bushels](#) compared to [172 bushels per acre for the U.S.](#)<sup>4</sup> This means that Cuba has a [persistent need to import food](#). To purchase imported food, Cuba must accumulate hard currency. The food production problem is

<sup>3</sup> Of course, the [steady emigration of Cubans](#) suggests some degree of dissatisfaction and this dissatisfied population leaves instead of pushing for regime change.

<sup>4</sup> [Mexico's corn production is around 60 bushels per acre](#).

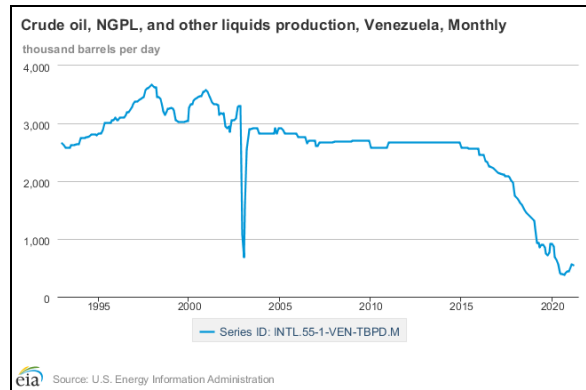
an important part of the backdrop to the current situation.

In addition, the current situation is a reflection of the predicament Cuba has always had—it’s a small island nation with limited resources and thus, to prosper, it needs a patron. Initially, Cuba relied on Spain. After independence and up to the revolution, the U.S. played that role. The Soviets were Havana’s patron until the fall of the U.S.S.R. Losing the Soviet Union caused a severe decline in economic activity. As the chart below shows, GDP fell sharply with the demise of the Soviet Union. Last year, GDP declined to levels last seen in the early 1990s. Although Cuba did enjoy stronger growth in the middle of the last decade, in the post-Global Financial Crisis era, its economic activity has been positive, but sluggish.



**Problem #1: The Collapse of Venezuela.**

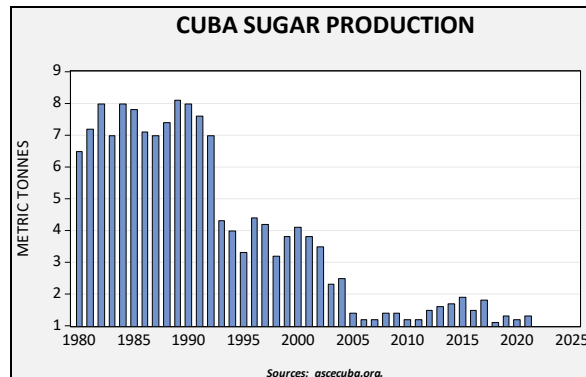
After losing Soviet patronage, Havana looked for a replacement. Fidel Castro cultivated a strong relationship with Hugo Chavez and the Venezuelan leader rewarded this friendship with cheap oil. Acquiring oil from Venezuela at favorable prices not only provided fuel but it allowed Havana to avoid spending hard currency on oil imports. Caracas was not a perfect substitute for Moscow, but it helped. Sadly, for Cuba, Venezuelan oil production has plummeted in recent years, the consequence of years of underinvestment in its oil industry.



Since 2015, Venezuelan oil production has steadily declined from around 2.7 mbpd to 0.5 mbpd. In 2012, Cuba received [166.3 kbpd of crude oil from Venezuela](#); last year, [that number fell to 62.0 kbpd](#). The decline in crude from Venezuela means that Havana must use hard currency to buy oil from elsewhere.

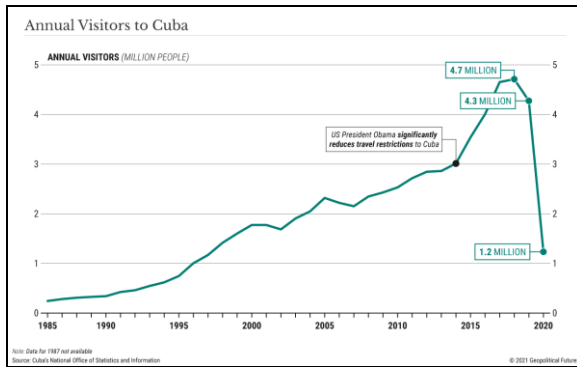
**Problem #2: The COVID-19 Pandemic.**

The most reliable source of hard currency for Cuba is tourism. Cuba’s other important export, sugar, has seen production fall since the collapse of the U.S.S.R.<sup>5</sup>



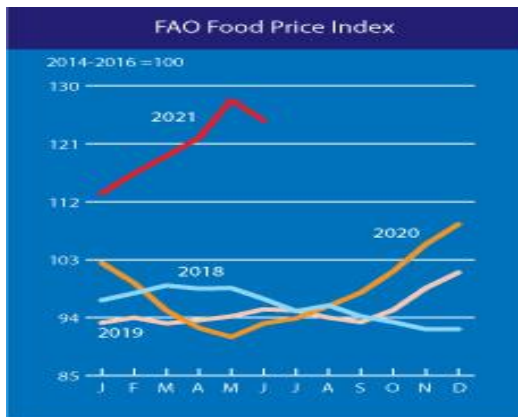
The pandemic adversely affected tourism, sharply reducing the hard currencies that come from tourists.

<sup>5</sup> Cuba and the U.S.S.R. had an arrangement where the former would swap sugar for oil from the latter.



(Source: [Geopolitical Futures](#); used with permission)

The pandemic has also [sent food prices soaring](#), which has increased the cost of imported food.



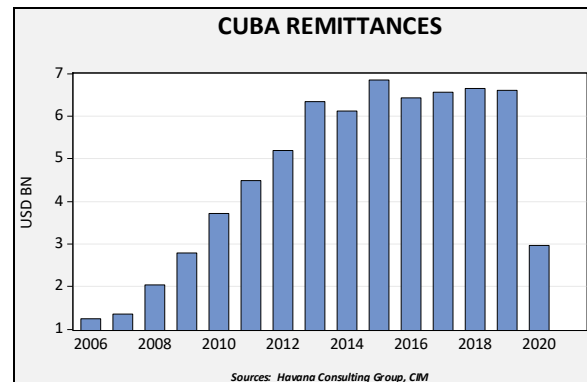
(Source: United Nations)

One of the positive features of Cuba is that Castro directed significant resources to public health. Given the country’s medical expertise, Cuba opted out of the [Covax vaccine program](#), determined to make its own. It has developed two vaccines, one named Abdala, which uses a three-shot protocol, and the other named Soberana. [Cuba claims the Abdala vaccine has an efficacy rate of 92.3% and Soberana has 62.0%](#). However, Havana has not submitted any clinical trial data to the WHO, so at this point, it is unclear how effective these vaccines are. Still, several nations, including Iran and Venezuela, have expressed interest in using the vaccines. Havana hopes to earn hard currency from licensing the production of its vaccines. However, if the efficacy rates prove invalid,

it would not only mean the loss of foreign revenue, but it would also indicate that Cuba does not have vaccines for its citizens.

Cuba’s handling of the virus was initially solid, [but in recent months, infection rates have risen rapidly](#). So, it is imperative that the country’s vaccines work.

Finally, the global decline in economic activity tied to the pandemic led to a falloff in remittances. As the U.S. economy contracted due to the lockdowns tied to the pandemic, the economy and incomes declined. Thus, the ability of Cuban-Americans to send money and material to family back on the island was constricted.



This decline reduced hard currency in Cuba.<sup>6</sup>

**Problem #3: Foreign Exchange Policy.**

Since the end of the Soviet Union, as the above GDP chart shows, Cuba’s economy has struggled. In general, during periods of weak economic growth, the government would ease restrictions on private economic activity. Entrepreneurship would surge and the economy would improve. However, inequality would also rise, and at some

<sup>6</sup> It should also be noted that the Trump administration [sanctioned Fincimex](#), a Western Union (WU, USD, 23.01) affiliate with ties to the Cuban military. This action has made transferring funds difficult.

point, the divisions were seen as a problem. Consequently, the Communist Party would implement new restrictions on private economic activity, and soon after, economic growth would decline.

During these periods of easing restrictions, Havana developed various methods to collect the hard currency that these enterprises would accumulate. For the past three decades, Cuba has deployed a dual currency exchange rate system. One currency was known as the Cuban national peso (CUP) and the other was a convertible peso (CUC). The former only circulated in Cuba and could only be used to buy goods and services produced in Cuba or imported by the state. Goods in stores that accept CUP and CUC were heavily subsidized and included some goods that were rationed and sold by ration cards. There were also hard currency stores that only accepted CUC and were mostly stocked with imported goods which were heavily taxed.

Fidel Castro created this system in 1993; from 1979 until the new system was created, it was illegal to hold U.S. dollars. But, by the early 1990s, the black market had become so pervasive that Castro was forced to accept that he had lost some degree of control over the monetary system. The dual currency system gave the state a way to capture dollars and other hard currencies circulating in Cuba. By creating hard currency stores, Cubans who received funds from Europe or the U.S., or workers involved in tourism who were paid in hard currencies, could shop at these stores and buy higher quality imported goods. As noted, goods in the hard currency stores were heavily taxed, giving the government twin benefits; it increased the margins on imported goods sold in Cuba and it allowed the state to collect hard currency. Cubans

swapped their dollars or euros for CUC, which were pegged 1:1 to the dollar.

In general, dual currency systems are created to achieve certain goals. Often, advantaged exchange rates will allow those with access to the overvalued rate to purchase what are effectively subsidized imports. In Cuba's case, the goal was to sop up hard currencies in the economy. The CUP program was effective enough that in 2004, the government removed dollars as legal tender. The CUC remained with its 1:1 peg, and CUC had a 24:1 peg to the CUP, at least to Cuban households. State enterprises were allowed to exchange CUP/CUC at 1:1.

Over time, the dual exchange rate system created distortions in the economy. It greatly rewarded those who worked in the dollar economy often in low-skilled professions. Those who worked in skilled jobs for the state, paid in CUP, saw their standards of living decline. And so, these highly trained workers, often engineers, doctors, or teachers, were incentivized to leave state employment for jobs driving taxis and waiting tables for tourists. In addition, those with CUC could buy subsidized goods in state-owned stores, exacerbating inequality. Finally, state enterprises, which received a deeply subsidized exchange rate, lost the incentive to compete on global markets.

Due to these distortions, the government had been considering ways to end the dual exchange rate system. After several years of planning, Cuba formally ended the program on [New Year's Day, 2021](#). The result has been disastrous, although the fallout took a few months to be felt. The CUC continued to exist for six months at a 24:1 CUP/CUC rate. But in June, the exchange rate moved to 1:1, causing the money supply to expand.

Essentially, the move was the equivalent of increasing the money supply 24-fold. In addition, to address the distortions caused by the dual exchange rate system, [wages for state workers were boosted by 525%](#). The devaluation and expansion of the money supply have led to a [jump in inflation](#). At present, it is difficult to determine the actual level of inflation, but [some economists estimate it is running at 500%](#).

The inflation has led to a scramble for hard currency, which, for the reasons we have discussed above, is scarce. Exacerbating this problem is a decision by the government to stop accepting dollars for deposit at banks on June 21. Although this may have been a ploy to encourage deposits before the deadline, the decision also increased uncertainty about exchange rate policy.

Essentially, Cuba is facing a balance of payments problem. Its avenues of acquiring hard currency, namely, remittances and tourism, have been adversely affected by the pandemic. The government, due to its attempt to unify the exchange rate system, expanded the money supply, causing significant inflation, which has led to widespread protests described above.

### **What's Next?**

The best solution for ending the protests is to increase imports by acquiring hard currency. An improving U.S. economy should help as well. Although the U.S. has made it somewhat more difficult to move dollars to Cuba, families usually develop workarounds. A global recovery from COVID-19, which would lift tourism, would help too. However, peak tourism for the Caribbean is during winter, meaning that in the best of circumstances, help is months away. In the last major downturn, in the early 1990s, Fidel Castro allowed for an expansion of private enterprise. Because he

had revolutionary credibility, his backtracking on socialism was accepted. Diaz-Canel has no such credibility. He is responding with hard crackdowns, arresting hundreds, and [handing out sentences without trials](#). But, so far, there has been no evidence of economic liberalization, [although some have argued that the president believes a China-style liberalization may be Cuba's only chance to improve its economy](#).

The traditional U.S. response is to maintain the embargo and accept Cuban refugees. So far, the Biden administration seems to be [struggling to develop a strategy](#). For example, [Homeland Security Secretary Mayorkas indicated that refugees who arrive by boat from Cuba will not be accepted](#), which seems ill advised. It appears the administration [wants to avoid a refugee crisis](#), but most Americans have a soft spot for those fleeing communism. The U.S., using the [Global Magnitsky Act](#), [has sanctioned some Cuban officials](#), including [Defense Minister Alvaro Lopez Miera](#).

Left-wing populists within the Democratic Party have [been pushing for Biden to lift the embargo](#). Politically, this is difficult; lifting the embargo would seem to help the regime's economy and allow them to continue to oppress the opposition. However, there is another argument in support of lifting the embargo. As noted above, Cuba has always needed a patron to support its economy. Lifting the embargo and making Havana dependent on the U.S. would tend to undermine the revolution. Clearly, there is a risk that the government takes the money and remains communist. But, so far, nothing else has worked. In the current political environment, however, it is likely that only a GOP president could enact such a maneuver, sort of a "Nixon to China" moment.

For now, we expect the regime to muddle along. We would expect refugees to come to the U.S. despite the warning from Homeland Security. Although regimes such as Cuba do sometimes fail, the ability of Cubans to emigrate likely prevents a wholesale collapse of the government. As the pandemic eases, conditions should improve.

### **Ramifications**

Market effects from this event will probably be modest at best. An improvement in economic and public health conditions might lead to the return of tourists and thus support those industries. Despite the embargo, the U.S. is the third largest

provider of foodstuffs to Cuba,<sup>7</sup> so we suspect there has been some contraction of demand in the crisis. However, Cuba is such a small importer relative to others that we doubt U.S. exports will be affected much either way.

Perhaps the biggest factor is political. If the Biden administration is seen as bungling the response, it might affect the 2022 midterms. A divided government would likely not pass much legislation, which would probably be bond bullish.

Bill O’Grady  
July 26, 2021

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<sup>7</sup> [The EU is the largest, with Brazil and the U.S. nearly identical.](#)

*This report was prepared by Bill O’Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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