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# MONETARY PROBLEMS OF AN EXPORT ECONOMY

THE CUBAN EXPERIENCE 1914–1947

*Henry Christopher Wallich*

1950

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To  
My Mother



## PREFACE

THIS VOLUME contains a study of Cuban monetary experience during the period from 1914 to 1947. The events are interesting even from a purely historical viewpoint; the main purpose of the study, however, is to examine, in the light of this experience, the working of monetary forces in an "export economy."

Cuba, with its almost exclusive reliance upon sugar exports, exhibits in an extreme form some of the problems peculiar to many export economies that have not yet achieved advanced economic development. These countries account for a sizable share of the world's population and resources. Their economic development not only is the foremost preoccupation of their own governments, but has also become the announced policy of the United States. Toward the understanding of the special problems and needs of such export economies, the present volume endeavors to make a modest contribution.

With this aim in mind, I have divided the study into two major sections, one descriptive and historical, the other analytical. The first section (Chapters I–XI) begins with an over-all appraisal of what the Cuban economy is and what it does, and proceeds to review Cuban monetary events and policies since 1914. Interest here centers chiefly upon the consequences, good and bad, of Cuba's lack of an independent monetary system. Particular attention is given to the nature of the policy alternatives that under these circumstances presented themselves to the monetary authorities at various times.

The second half of the book (Chapters XII–XV) is largely analytical. It discusses the forces that govern the Cuban economy and attempts to bring modern economic analysis to bear upon the peculiarities of a monocultural export economy. Particular attention is devoted to the processes of cyclical expansion and contraction, to the mechanism of balance of payments adjustment, to the potential effects of exchange rate variation



and exchange control. The last chapter discusses the problems of central banking policy in a country of Cuba's economic structure.

Only very limited attention, unfortunately, could be given to questions of developmental financing. This is a subject which is acquiring increasing importance for underdeveloped countries, but Cuba's otherwise rich monetary experience includes no episode bearing upon financial aspects of developmental programs. Consequently, the treatment of this topic has had to remain restricted to a rather brief section in the chapter on central banking.

The study was begun in 1942 and virtually completed in 1944, but events have delayed its being readied for publication. I have endeavored to bring it up to date as to facts and methods of analysis, but I am conscious that the lapse of some years has involved changes in viewpoint that have left traces on the structure of the book. This is particularly true of the historical sections, originally intended as the core of the work but eventually reduced to the role of an introduction to the analytical discussions. The reader not primarily interested in Cuban economic history will lose little, if after an initial briefing on the general background in Part I, he immediately turns to Part IV, "The Significance of Cuban Monetary Experience."

For guidance in the formulation of the present materials, as well as for the orientation of my general approach to monetary questions, I am lastingly indebted to Professor John H. Williams and Professor Alvin H. Hansen of Harvard. For advice and information on matters relating specifically to the Cuban environment, I have to thank Dr. Felipe Pazos, Dr. Walterio Leza, Dr. Julián Alienes, Dr. José Antonio Guerra, Dr. Raúl Maestri, Dr. Rufo López Fresquet, and Mr. Louis Naetzker. The chapter on the central bank is influenced, in large measure, by the ideas of Dr. Raúl Prebisch and Dr. Robert Triffin. To my present and past colleagues in the Federal Reserve Bank of New York, particularly Arthur Bloomfield and Frank Tamagna, I am indebted for advice on many specific points, and for numerous and animated discussions over a period of five years which have served to clarify the problems discussed in the book

and to broaden its scope. Sincere acknowledgments also are due to Philip Glaessner, who contributed substantially to the statistical material, to Winthrop W. Case, who painstakingly edited the manuscript, and to my secretary Miss Doris Kellerman and others who, over a period of seven years, have typed the manuscript.

Finally, I should like to express my gratitude to the Federal Reserve Bank of New York for the opportunities it has offered for both study and experience in the international financial field, from which this book has benefited. I need hardly add that the responsibility for the views expressed and for any errors present in the book is solely my own.

New York  
June 1949

H. C. W.



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**PART I**  
**INTRODUCTION**



## CHAPTER I

### SOME GENERAL REFLECTIONS ABOUT THE CUBAN ECONOMY <sup>1</sup>

ALTHOUGH EXACT DATA are lacking, it seems safe to say that among all tropical countries Cuba has the highest per capita national income. This income is produced by a highly capitalized economy concentrating upon a single export product — sugar. By pushing specialization to an unusual extent, the Cuban economy has been able to turn in an exceptional performance.

For these gains, however, Cuba has had to pay a high price. Its efficient sugar economy has proved highly vulnerable to world market fluctuations and has been increasingly exposed to import restrictions abroad. At times it has dragged the country through the depths of depression; at other times, stimulated by abnormal demand, it has virtually exploded in inflationary booms. For these reasons, it is widely felt in Cuba that specialization has been overdone and that a more diversified and stable economy must be developed.

Cuba's situation is of course no accident, but the result of more or less clearly discernible circumstances. In this chapter, an attempt will be made to trace the factors that have produced the Cuban economy, to analyze the way in which it now functions, and to look ahead in the direction in which it may develop.

#### I. BALANCE SHEET AND INCOME STATEMENT

The resources and activities of an economy can perhaps be best summarized in a form resembling a corporate balance sheet and income statement — the balance sheet being repre-

<sup>1</sup>In writing this chapter, I have benefited greatly by the ideas and advice of many of my Cuban friends and colleagues — especially Felipe Pazos, Julián Alienes, José Antonio Guerra, and Raúl Maestri, but also others whose contribution is acknowledged in the preface.

sented by an account of the economy's human, natural, and man-made resources and the income statement by a breakdown of its gross national product and balance of payments.

#### A. THE BALANCE SHEET

Cuba's population, like that of the United States, is almost entirely the product of immigration. Cuba's economic history therefore is intimately tied up with the flow of immigrants in recent and more remote days. In past centuries it was the importation of African slaves that facilitated the earlier development of the sugar industry. During the first quarter of the twentieth century it was the movement of Spanish immigrants that made Cuba "Spain's New World" and supplied a large part of the human resources required for the great sugar expansion that culminated in 1925. The subsequent reversal of the expansionary trend, and the severely restrictive national labor legislation called forth by this change, virtually brought immigration to a halt during the second quarter of the present century.

At present Cuba's population totals slightly over 5,000,000; the total labor force in 1943 was estimated at 1,671,000. The sugar industry is by far the largest employer of labor, primarily in its agricultural sector. The simple nature of the work required in that sector has kept large numbers of workers from acquiring more than elementary skills, but the industrial sector has stimulated the development of a skilled labor force of some importance.

Cuban labor in general has shown itself hardworking and adaptable to modern techniques. In recent years there has been intensive union organization of labor. The resulting extreme pressure for higher wages and job security, fortified by government backing and often combined with resistance to technological improvements, has created serious problems for some industries. This pressure probably has increased the tendency toward unemployment which has prevailed steadily except at the peak of the war boom and which is aggravated by the seasonal character of the sugar industry. Cuban unemployment therefore cannot be regarded as wholly "involuntary," although it appears that the organized sector of labor has succeeded in

partly shifting the burden of unemployment to the unorganized sector.

In addition to its capable labor force, Cuba counts among its human resources a large number of energetic and competent entrepreneurs and administrators, who have been schooled in large-scale operations through the great development of the sugar industry and other enterprises. Like similar groups elsewhere, the Cuban businessman possesses special traits that have had a distinct influence upon the development of the economy. We shall note these in more detail later on.

Cuba's chief natural resource is the abundance of fertile land, much of it as yet unutilized.<sup>2</sup> Mineral resources are present on a moderate scale, but except in wartime their exploitation has not been particularly attractive. Cuba's wealth of arable land has protected the country against the population pressure from which many other Caribbean economies suffer. Since land has always been the cheapest factor of production in Cuba, cultivation of sugar cane and most other crops has been extensive rather than intensive, although there are some signs that the extensive method is beginning to suffer from sharply diminishing returns.

The main limitations of Cuban agriculture are those imposed by the island's geography and its climate. Cuba has 44,164 square miles and extends for a distance of 780 miles, but since this extension is east-west and not north-south and since the island lacks an elevated plateau, it also lacks the climatic differences that would permit a fully diversified agriculture. The tropical climate is all-pervasive. It prevents some crops altogether, such as wheat, and its succession of dry and wet seasons imposes a severely seasonal rhythm upon the economy. This natural seasonality is greatly intensified by the peculiarities of the sugar industry and has had profound social and economic consequences.

From the political point of view, the island's location gives it considerable strategic importance for the United States, as is indicated by the existence since the early 1900's of a United

<sup>2</sup> P. G. Minneman, *The Agriculture of Cuba* (Department of Agriculture, Foreign Agriculture Bulletin No. 2, Washington, 1942), p. 16.

States Navy base at Guantánamo Bay. In the sociological sphere, the closeness to the United States, combined with other factors, has resulted in large parts of the urban population being influenced by forms of American living. From the economic point of view, Cuba's location so close to the highly industrialized Eastern Seaboard, which permits goods to be shipped thence more cheaply to Havana than to Texas, has likewise had a profound influence.

Capital, the third major asset in Cuba's balance sheet, has in common with natural resources the fact that in the Cuban economy it is being applied in large quantities to a limited labor force. Cuba almost certainly is more heavily capitalized in relation to population than any other Latin American country, and *a fortiori*, than any other tropical country. This is of course the necessary though not sufficient condition of Cuba's high per capita income.

Capital in Cuba, however, is highly concentrated as to field of application and ownership. The largest share undoubtedly is employed in the sugar industry. Public utilities and transportation come next; there is very little other industrial or agricultural capital. The ownership of this capital is concentrated in foreign hands to a degree unusual even for an export economy. Sugar is estimated to be approximately 50 per cent foreign owned, utilities and transport even more so, and banking and insurance are also in good part foreign controlled. Most of the foreign capital is, of course, American. British capital consists mostly of railroad investments, which for some time have yielded very little. Domestic capital has in large part gone into real estate investments, traditional in Latin America, which absorb a considerable proportion of domestic saving.

#### B. THE INCOME STATEMENT — CUBA'S GROSS NATIONAL PRODUCT AND BALANCE OF PAYMENTS

The foregoing review of Cuba's resources has given some idea of what the economy is. An even briefer survey of Cuba's gross national product and balance of payments will show what it does.

Data on the size and composition of the gross national prod-

uct are extremely scanty, but one may perhaps assume that it was about 500 million dollars in 1938-39, and 1,500-2,000 million in 1947-48. The estimated composition of the gross national product is shown in the accompanying table.<sup>3</sup>

COMPOSITION OF GROSS NATIONAL PRODUCT  
(data for 1938)

| <i>Economic activity</i>                  | <i>Per cent of<br/>gross national product</i> |
|-------------------------------------------|-----------------------------------------------|
| Sugar and sugar by-products . . . . .     | 22.4                                          |
| Agricultural sector . . . . .             | (8.2)                                         |
| Industrial sector . . . . .               | (14.2)                                        |
| Other agriculture and livestock . . . . . | 13.4                                          |
| Other industry . . . . .                  | 12.6                                          |
| Forestry, mining, and fishing . . . . .   | 2.3                                           |
| Transportation . . . . .                  | 2.5                                           |
| Commercial services . . . . .             | 17.8                                          |
| Financial services . . . . .              | 3.6                                           |
| Rents . . . . .                           | 11.5                                          |
| Professional services . . . . .           | 2.7                                           |
| Government services . . . . .             | 10.7                                          |
| Other services . . . . .                  | .5                                            |

The most striking aspect of the table is that sugar, taking its agricultural and industrial sectors jointly, accounted for 22.4 per cent of the total. Other industrial activities accounted for 12.6 per cent, other agricultural for 13.4 per cent, and commercial and financial pursuits for 21.4 per cent.

Of the distribution of this gross national product among the various producer groups very little is known. Owing to the smallness of the middle class, a characteristic of most under-

<sup>3</sup> Based on Alienes' estimate of the value of "National Production" in 1938, in Chamber of Commerce of the Republic of Cuba, *Directorio Oficial de Exportación e Importación, Producción y Turismo 1941*, pp. 84-86. Alienes' estimate of the gross national product used the "net value added" method and covered the most important private economic activities. It omitted, however, government services and a number of private services. The estimate has, therefore, been complemented on the following basis: (1) the value of government services in 1938 was estimated independently; (2) the value of financial services, rents, professional and other services was estimated by adjusting for price changes data taken from Eduardo Durruthy's 1943 estimate of "national income paid out" reproduced in National Bureau of Economic Research, *Studies in Income and Wealth*, X, 203-204.



developed countries, the distribution of income is bound to be highly unequal. Nevertheless, it is believed that the attempts of the government during and after the war to "spread the boom thin" have succeeded in mitigating this inequality somewhat. It may be noted that in 1947 between 2.2 per cent and 3.8 per cent of the total gross national product went abroad as return on foreign capital.

In addition to the inequality among the different income brackets, there appears to be considerable inequality as between the cities and the country. It is because of the low standard of living in the rural areas that, despite Cuba's leadership among tropical countries in national income per capita, it is doubtful whether one may speak also of leadership in living standards for the population as a whole.

An analysis of the data entering into Cuba's balance of payments for 1947 shows that exports accounted for 94 per cent of total receipts on current account and that of these exports 85 per cent consisted of sugar. Tobacco was next with 5 per cent of total exports. Imports amounted to 74 per cent of total current payments (see accompanying tabulation).<sup>4</sup>

#### STRUCTURE OF BALANCE OF PAYMENTS

(*Current Account, data for 1947*)

|                                           | <i>Per cent of<br/>total receipts</i> |                                           | <i>Per cent of<br/>total payments</i> |
|-------------------------------------------|---------------------------------------|-------------------------------------------|---------------------------------------|
| Exports.... .                             | 94.0                                  | Imports. . . . .                          | 73.8                                  |
| Sugar and sugar by-<br>products.... .     | (80.1)                                |                                           |                                       |
| Foreign travel.... .                      | 2.7                                   | Foreign travel . . . . .                  | 7.6                                   |
| Freight . . . . .                         | .1                                    | Freight . . . . .                         | 4.9                                   |
| Investment income . . .                   | .1                                    | Investment income . . . .                 | 10.6                                  |
| Other current transac-<br>tions . . . . . | 3.1                                   | Other current transac-<br>tions . . . . . | 3.1                                   |

<sup>4</sup> In 1947, there were changes in net exchange resources amounting to 9.2 per cent and net autonomous capital movements, errors and omissions amounting to 5.1 per cent of receipts on current account; these items have been omitted here, because they do not represent structural ingredients. The dollar values and a short discussion of the official Cuban estimate of the balance of payments in 1947 is given in Appendix B.

In contrast to the high specialization of exports, imports show the wide diversity to be expected in an underdeveloped country. Despite the agricultural character of the island, a sizable volume of foodstuffs is imported, particularly wheat and wheat flour, rice, lard, and beans. However, Cuba's ability to provide her own food has increased considerably as a result of the 1927 tariff and the subsequent diversification efforts. This is reflected in the fact that imports of foodstuffs, as a proportion of total imports, dropped from an average of 37.8 per cent in 1924-1929 to 26.7 per cent for 1935-1939, although the special circumstances of the war period raised the proportion to 31.7 per cent. In fact, the advance in food self-sufficiency is not fully revealed by these figures, because many manufactured products that used to be imported also are now produced in the country.

A study of the various accounts in the balance of payments, based on the data in Appendix B, shows that the movements of most of them are functionally related to the movement of exports. Analytically this relation can usually be traced either to direct dependence upon exports or to an indirect dependence via the relation between exports and national income. This relation, of course, is bound to be very close in view of the high ratio of exports to gross national product. The subject will be studied in detail in Chapter XII, "Strategic Forces in the Cuban Economy."

The great importance of foreign trade also implies that the movement of the terms of trade is of primary significance to Cuban welfare. The factors determining the terms of trade — that is, the characteristics of supply and demand for Cuban exports and imports — will be discussed in Chapter XIII, "The Pros and Cons of Depreciation." Finally, the significance of the fact that Cuban foreign trade so far has not been subjected to effective foreign exchange control, and that Cuban agricultural and industrial development has not had the advantages, real and imagined, of this type of protection, will be analyzed in Chapter XIV, "A Case for Exchange Control?"

## 2. THE ROLE OF SUGAR IN THE ECONOMY

Cuban sugar accounts for 20 to 30 per cent of the gross national product and at the height of the season gives employment to one-third or more of the labor force. Sugar is grown from one end of the island to the other; it is the sole "big business" (apart from the big business of government) of the country; it permeates everybody's thought and conversation. No wonder, therefore, that Cuba has a pronounced "sugar mentality."

Although it is customary nowadays to emphasize the drawbacks of the sugar economy — and there is indeed much to be said on that score — it is quite obvious that sugar has done a great deal for Cuba. Sugar lends itself like no other tropical product to the application of large amounts of capital. In contrast to coffee, rubber, tea, cocoa, and similar products, it calls for heavy installations in the areas where the raw material is actually produced and seems to show increasing returns, in relation to the scale of operations, up to very large units. The application of such heavy doses of capital to the other factors of production allows the latter to reach a very high level of productivity, provided their total volume is limited, as is the case of Cuban labor.<sup>5</sup> Because Cuban soil and climate favor sugar production and because the special relations between Cuba and the United States have made it easy and safe for large amounts of American capital to enter the country, Cuban labor and entrepreneurs have been able to reach a level of productivity in sugar that in other products they hardly would have attained.

But besides these positive aspects, the sugar economy exhibits several serious weaknesses. When these are properly evaluated, it will appear that: (1) the sugar industry as it now operates is far from being perfectly adapted to the country's needs; (2) increasing specialization in sugar would probably be undesirable even if it were feasible marketwise; and (3)

<sup>5</sup> The almost unlimited availability of land in Cuba has reduced its marginal productivity to a very low level, as is indicated by the system of extensive cultivation prevailing.

actual market prospects and other factors make it seem advisable to push aggressively the development of a more diversified economy. At the same time, however, it is clear that sugar is bound to continue the mainstay of the economy for the foreseeable future.

The problems presented by sugar are partly of an internal, partly of an external, nature. Among the latter are those typical of many other export economies. They will be treated in a later section. The internal problems likewise are by no means exclusive to sugar but are characteristic to some degree of many tropical raw materials. In the sugar economy, however, these problems of social structure, of economic mentality, and of full employment of resources have manifested themselves with peculiar intensity.

The most serious social problem of the sugar industry is its tendency to create a small upper class of unenterprising entrepreneurs caught in a sterile routine, together with a large class of unskilled plantation laborers who have no chance to improve their social and economic condition. In his classic study *Azúcar y Población en las Antillas*, Ramiro Guerra has shown how under circumstances where labor is plentiful and land is not, the sugar industry tends to drive out small landowners and producers of competing products and to establish a plantation routine that blocks all development including its own. In Cuba this ultimate stagnation has never been approached, because the further expansion of the industry has been blocked by unfavorable market conditions and because the supply of labor has remained limited while land has remained plentiful. The adverse social effects of the unskilled nature of the agricultural work required by sugar, however, have been felt to some extent, although in ordinary times the standard of living even of the agricultural sugar worker has been considerably above a mere existence minimum.

Closely related to the social problem is the psychological one of the "sugar mentality." In Cuba the outcome of all enterprise depends ultimately upon sugar, and whether sugar does well or poorly depends upon conditions abroad. The individual's economic fate is therefore determined to a higher degree than

elsewhere by forces beyond his and his nation's control. The violence of sugar fluctuations is such that a moderate rise in the price can do more for most Cubans than can a great deal of hard work, saving, and investing. It is therefore more than understandable if businessmen think primarily in terms of getting their share of whatever gains may be in store for sugar, and are reluctant to sacrifice that chance in favor of some other enterprise that in any case is bound to suffer if sugar suffers. It is equally understandable if the government thinks more in terms of what can be done to raise the price of sugar by a small fraction of a cent than in terms of the perhaps more secure but less immediate rewards of developmental effort. When the lottery of the international sugar markets distributes the big prizes, the small pickings of other enterprises are bound to seem unimpressive.

At the same time, of course, this tendency to pin all hopes on the international sugar markets gives sugar an economic and political dominance even greater than its true weight in the economy. Sugar dominates the economic policy of the country, and other interests must stand aside in the interest of sugar. This is exemplified, for instance, by Cuban commercial relations with the United States, where fairly sizable Cuban tariff concessions, limiting the possibilities of domestic industry, have served more or less as the price for a reasonable sugar quota in the United States market. This tendency of the dominant interest to perpetuate itself leads into a vicious circle that is hard to break.

Finally, there is the problem of the full utilization of resources that the seasonal character of the sugar industry presents in an unusually severe form. Of course, all activities based on agriculture are to some extent seasonal, but few as severely so as sugar. The cutting of cane and production of raw sugar must take place during the dry season, lasting from December or January to April or May. While the crop is being made, the mills must operate around the clock and everybody works feverishly. When the crop is over, there is only maintenance work in the mills, and light work in the cane fields, which together absorb only a fraction of the labor required at the

peak. The rhythm of many other crops, and even the winter tourist season, coincide with the sugar season and intensify its effects.

In some tropical countries where the seasonal movement is less violent, and where there is a sizable subsistence sector, the economy somehow succeeds in absorbing the seasonal slack with diverse local activities. The result is underemployment rather than open unemployment. Cuba, however, lacks the elastic base of a subsistence sector. The sharp rhythm of dry and wet seasons, the nature of sugar work, the distribution of land ownership, and the habits of cultivation all conspire against efforts to create off-season activities, although a good deal more could undoubtedly be done. The problem is, therefore, that of the worker who must eat, and of the machine that must pay interest for an entire year, out of the product of three to five months' work. Even though, in times of reasonable prices, worker and machine are quite successful in so doing, this form of operation of the sugar industry involves a serious under-utilization of resources.

### 3. SUGAR AND FOREIGN TRADE

A description of the factors determining Cuba's foreign trade, like that of the internal structure of the economy, inevitably runs in terms of sugar. Tobacco, fruits, vegetables, and minerals do no more than round out a picture dominated by sugar. The aspects of Cuba's international economic relations that will be discussed in this section are: (1) those deriving from the peculiarities of the markets for Cuban sugar and (2) certain general problems that Cuba shares with many other export economies.

#### A. MARKETS

The history of Cuban sugar markets, and indeed of the industry itself, is in good part a history of relations between Cuba and the United States. Even during the colonial period, Cuba was developing, largely out of domestic resources, a sizable sugar industry that was oriented towards the United States. The special relations established between Cuba and the United

States at the end of the war with Spain — the Platt Amendment, the Reciprocity Treaty,<sup>6</sup> and the legal tender status and consequent internal use of the United States dollar — were to some extent only an expression of already existing tendencies, although they also produced a great intensification of these tendencies.<sup>7</sup> United States investors as a result came to enjoy a degree of political and economic safety in Cuba such as they had in no other Latin American country, in addition to a large and assured market for Cuban sugar in their own home country. American capital therefore flowed in on a large scale. As a result of these special relations with the United States, Cuba became more highly capitalized, more specialized — and probably more economically unstable — than she would have been had her historical development followed that of the other Latin American Republics.

After 1934 Cuba's share in the United States sugar market became stabilized by the quota system. The preference granted under the Cuban Reciprocity Treaty therewith lost much of its earlier significance. It has been argued with some cogency that, although the preference may have been of great importance in the past in enabling both countries to establish themselves firmly in each other's markets, it now offers only moderate gains to either side. For Cuba, moreover, it has become an impediment to effective trade bargaining with third countries and an obstacle to a tariff policy aimed at supporting her industrial ambitions.

The importance to Cuba of third countries lies chiefly in the fact that they are the marginal purchasers of Cuban sugar. Prices in the so-called "world market," that is, outside the United States quota system, have usually been lower than

<sup>6</sup> Also known as the "Permanent Treaty," the Platt Amendment was embodied in the Cuban Constitution of 1901, but was abrogated in 1934; it provided that under certain circumstances the United States would intervene in Cuban affairs. The Reciprocity Treaty was first signed in 1902 and was superseded by the Trade Agreement of 1934 and its supplemental agreements of 1939 and 1941. Both the 1902 and 1934 pacts provided for preferential tariff rates to apply to trade between Cuba and the United States.

<sup>7</sup> See Philip G. Wright, *The Cuban Situation and Our Treaty Relations* (Washington, 1931), p. 9; also Tariff Commission, *The Effects of the Cuban Reciprocity Treaty of 1902* (Washington, 1929), p. 9.

within this system, and the volume of sales has been much smaller, but the world market is nevertheless of great importance to Cuba, given the limitation of her United States quota. This market, however, has become continually smaller since the 1920's. After the bitter competitive battles of the early thirties, the International Sugar Agreement stabilized Cuba's share in the "world market," with the result that all of Cuba's sugar exports became subject to regulation. The aftereffects of the war have further reduced this market and have further weakened the peacetime position of Cuban sugar.

Cuban sugar is highly vulnerable to import restrictions, because sugar is not an absolute essential and because many countries can replace it to some extent with domestic or colonial production. The experience of wartime shortages of sugar, with its great military importance, and of skyrocketing postwar sugar prices, has given further impetus in many countries to self-sufficiency drives in this product.

All these circumstances make the future of Cuban sugar on the world market quite uncertain. Cuba's heavy reliance upon the United States market, although it seems to imply an inadvisable dependence upon a single customer and hence an excessive concentration of risk, may therefore actually prove a factor of safety. The United States, for many reasons of political and economic self-interest, is bound to feel a sense of responsibility for Cuba's welfare and stability that other foreign countries certainly have not shown. A stable relationship of this sort may in the long run prove safer than relations with a variety of markets that may become closed overnight.

Several aspects of Cuba's market structure are of particular interest. In the first place, it will be noted that under the quota regime the demand for Cuban sugar is almost completely inelastic (see Chapter XIII, "The Pros and Cons of Depreciation," for the interesting consequences of this situation for Cuba's foreign exchange policy). In the second place, the predominance of the United States in Cuba's export picture implies that Cuba is relatively less vulnerable to "soft currency" problems than many other large export economies. The sale of approximately one million tons of sugar annually outside the United



States that Cuba hopes to maintain, as well as the sale of a good part of Cuba's tobacco output, implies, it is true, a sizable volume of trade with "soft currency" areas. But so long as the vastly larger part of Cuba's output goes to the United States and Cuba's trade structure therefore is basically not triangular, as is that for instance of Canada or Argentina, Cuba need not anticipate problems of inconvertibility of customer currencies on a scale such as that which has been experienced by these two countries.

Finally, experience over the last 30 to 40 years suggests that Cuba may be facing a secular deterioration of her terms of trade. While precise data are lacking, it seems evident that the downward trend of sugar prices during the interwar period was more pronounced than that of many other raw materials. It is also noteworthy that despite the sharp rise in sugar prices during and after the war, Cuba on the whole did not enjoy an improvement in her terms of trade during this period. A continuing downward trend in the terms of trade, should it materialize, would of course add a further reason to those already existing for a policy of diversified agricultural and industrial development.

#### B. THE DIFFICULTIES OF LIVING BY EXPORTING

In addition to the specific advantages and disadvantages associated with individual export products, there are certain general problems that any export economy must face, no matter what it produces. A technical treatment of these matters will be found in Chapters XII and XV on "Strategic Forces" and "Central Banking"; a few summarizing comments on the broader aspects will therefore suffice here.

The most obvious feature of an export economy like the Cuban is that exports and imports respectively assume the roles that, in an "investment economy" like that of the United States, are played by investment and saving. Exports rather than investment are the main generating force in the national income; imports rather than saving represent the main leakage from the income stream. This implies that the Cuban economy tends to play a passive role in world-wide fluctuations: it reacts

to them but it does little to originate them. This is an advantage insofar as the country does not greatly need to fear depressions brought on by internal circumstances, but also a danger because of the country's vulnerability to depressions abroad.

In addition to being exposed to "imported" booms and depressions, the Cuban economy is less well equipped than an "investment economy" to take compensatory measures. The structure of the economy does not readily permit a shift of productive factors away from depressed export production to production for the home market. Moreover, an attempt to stimulate employment at such times is likely to run into trouble because of dwindling exchange availabilities.

Fluctuations in the Cuban economy are likely to be intensified by the perverse changes they occasion in liquidity. An active balance of payments increases the money supply at the same time that it raises national income. Instead of a growing stringency of money and credit during such periods, as has been characteristic of most American booms, Cuba experiences rising internal liquidity which intensifies the boom. During the downswing, on the other hand, when the balance of payments is passive, the money supply contracts sharply and thereby tends to aggravate the depression. A similarly perverse behavior may be observed with regard to international liquidity. Exchange reserves rise while the balance of payments continues active. When it turns passive and the upswing is thus brought to an end, exchange reserves decline. If internal credit expansion has previously created a large volume of funds unbacked by exchange resources, or if such expansion takes place during the downswing, a shortage of foreign exchange may develop. This latter difficulty, however, has so far been avoided in Cuba as a result of the conservative character of the banking system and the peculiarities of the monetary system.

We have already noted the advantage enjoyed by many tropical export economies but denied in good part to Cuba — the presence of a subsistence sector in the economy, into which unemployed labor can retire during depressions. Cuba certainly has enough agricultural resources to enable sugar workers to

cultivate subsistence crops, but little progress has been made in this direction. Seasonal and cyclical unemployment therefore appear in unmitigated form. For the same reason, the fluctuations in the terms of trade, to which raw-material countries are particularly exposed, are felt more severely in Cuba than in an export economy with a subsistence base. That the war and postwar boom did in fact bring no significant change in Cuba's terms of trade was a rather unusual deviation from Cuba's typical pattern.

#### 4. DEVELOPMENT

The production of sugar is "habit-forming" in the extreme. Some of the islands of the Caribbean have existed for centuries in this routine, which seems to deaden their ability and their will to change and progress. Cuba, fortunately, is not in this situation. Although there is a justifiable pride in the achievements of the sugar economy, there is also full awareness of its dangers and limitations. Cuba, like most other Latin American countries in recent years, has become distinctly development-conscious. This consciousness finds its expression in the desire, already noted, to diversify output, particularly in the direction of greater industrialization. In this section we shall survey the main reasons for this desire, as well as various special aspects likely to influence Cuba's development.

##### A. THE NEED FOR DEVELOPMENT

Sugar undoubtedly constitutes the most productive form of employment of Cuban resources, but it also involves numerous drawbacks. It has proved highly vulnerable to international fluctuations, and the resultant loss of income and employment during depressions has shown the need to build up alternative sources of export income or of domestic substitutes for imports. The routine of sugar production, furthermore, produces adverse social phenomena, the nature of which has been discussed above. Complete specialization in this direction would, therefore, carry distinct dangers, even if the situation in the sugar market permitted such specialization. As a matter of

fact, however, the limitations on the foreign sale of Cuban sugar implies that supplementary activities must in any case be developed if Cuba's abundant national resources and growing population are to be fully employed. In other words, the problem is not one of cutting back sugar production in favor of less productive but stabler and socially preferable activities, but of utilizing resources that today are seasonally or permanently idle.

A final factor favoring diversification that bulks large today, although it may not prove permanent, is the effort of European countries to reduce their imports from the hard-currency areas. Cuba, even though it may cease to use the dollar for internal purposes, forms part of the dollar area. Unless Cuba can find ways of increasing her purchases from European countries, she may well find herself a victim of their drive to substitute domestic and colonial sources of supply for hard-currency imports. From a long-term point of view, however, it is probably too early to appraise the effects of this drive upon the world market for sugar.

#### B. RESOURCES AND OPPORTUNITIES

The need for diversified development is clear, but how about the means? It is at this point that the misfortune of being a small country becomes very apparent. Diversification of output requires diversified resources and markets large enough to absorb the output. But most small countries, and Cuba among them, lack diversified resources, and their domestic markets often are too small for the optimum scale output of many industries. The natural and, to some extent, the inevitable result for a small country is for it to make its living chiefly by foreign trade and by specializing in the use of such resources as it has. Diversification and production for the home market are in a sense contrary to the natural tendencies in a country like Cuba; the question is therefore how their adverse implications can be minimized by appropriate adaptation to the conditions imposed by the available resources and markets.

Cuba's most obviously exploitable resource is the dead-

season capacity of the sugar mills and the abundance of arable but actually untilled land. Unemployed labor is also available, and there is a further reservoir of untapped human resources, for today only a small proportion of women work in Cuba. However, Cuban labor is high priced and has proved difficult to handle in recent years. Hence, the chances are that heavier application of capital to the other factors of production would prove more attractive than the more extensive application of labor, particularly since interest rates in Cuba are not high by Latin American standards, provided capital is available at all.

The latter point is an important one, for the availability of physical capital is limited, appearances to the contrary notwithstanding (and quite apart from the willingness to invest, which will be commented on below). It is of course true that in times of high sugar prices, savings in Cuba are high. These savings are in good part the result of the large profits accruing in the upper income brackets as a result of high export prices. Without them, the economy could not have the sizable export surpluses that in fact it does tend to have in boom times. But a large part of these savings cannot effectively be utilized for domestic investment because during boom times the factors of production are already fully employed — in good part in the production of the export surplus that is the counterpart of the savings. To increase domestic investment, it becomes necessary to bid away factors of production from existing pursuits — in other words, to generate more inflation.

This failure of financial savings to be matched by real resources available for investment was seen very clearly during the wartime and postwar boom, when the attempt to convert profits into residential and other construction, in the face of limitations of labor and materials, intensified the inflation. Of course, the financial savings might be set to work once the boom was over and labor and materials had become more freely available. But at that moment the incentive to invest would be considerably lessened. This dilemma of competition between exports and domestic investment, during those times when private capital is willing to invest, is typical of most export economies. It suggests that government action may have to

play a larger role in stimulating investment than would be necessary in an "investment economy" like the American. From another point of view, it also suggests that despite occasionally substantial savings in the Cuban economy, there continues to be a need for considerable foreign investment, even though foreign investment cannot provide a satisfactory answer to the shortage of real resources for investment during an export boom.

Important for Cuba's development is another instance of competition for limited resources — that which may eventually arise between the more highly diversified sectors of the Cuban economy and the sugar sector at boom levels. As said before, Cuba is relatively fortunate in not having to face this problem immediately, because existing limitations upon sugar output allow her to push diversification by utilizing surplus resources. It is clear, however, that eventually the building up of other activities will encroach upon the peak sugar output that could be attained during occasional periods of high demand. Diversification will thus limit the extent to which Cuba can benefit from sugar bonanzas, although the restriction of output may be compensated somewhat by higher prices. Furthermore, the successful development of other activities may eventually raise the cost level of the sugar industry, unless that industry continues to increase the efficiency of its operations. These, however, are problems for the future that might arise out of the success of measures required to solve more immediate difficulties. They argue against extreme notions for the revamping of the economy, but not against a reasonable policy of diversification.

From the foregoing discussion it appears that Cuba has the resources to develop a variety of agricultural lines, as well as numerous light industries. Heavier industries probably are out of the question for the time being. Of the feasible developments, some point in the direction of the world markets, while others would aim at the domestic market. In a free economy the decisions regarding the direction of development are determined mainly by market forces, but a certain element of national policy also enters into these decisions, to the extent that

the government may try to stimulate development through protection, credit aid, or other means. The question arises therefore of the direction of development that should be favored, although it is clear that any preference for industrial against agricultural, and for home-market against export-oriented development, can only be a matter of emphasis and should in no sense be exclusive.

In Cuba, as in most of Latin America, there appears to exist a tendency to think of "development" primarily in terms of building up industry in preference to agriculture and of working for the domestic rather than the international market. As far as aims rather than possibilities are concerned, this approach does indeed seem to offer very promising prospects, for it combines the advantages of growing national income with those of greater independence from foreign markets. In practice, however, the employment of Cuban resources in manufacture for the domestic market is probably the least efficient use to which they can be put, owing to that market's limitations. The smallness of the market completely rules out some industries that must operate on a large scale. In others, there may be room for but a single plant approaching optimum scale. In that case the alternatives would be, on one side, a moderately efficient monopoly and, on the other, a modest degree of competition among a group of inefficient producers. It is only in industries able to operate efficiently on a small scale that, after a certain growing-up period, a high level of productivity combined with a real measure of competition may eventually be attained.

In the light of Cuban traditions, fairly pronounced monopolistic tendencies would probably appear even in industries in which there were several producers. Monopolies in Cuba would hold none of the promise of innovation through which monopolies elsewhere have sometimes justified their existence; they would be wholly exploitative. While, in principle, foreign competition could be brought to bear upon any local monopoly through a reduction of tariffs or other forms of protection, experience has shown that this rarely happens and that small

local monopolies, once created, are usually allowed to go their inefficient way undisturbed. It therefore seems evident that proposals to give protection to small industrial ventures for the local market, often no doubt well justified, must be screened very carefully as to the enterprises' operating efficiency.

In addition to industrial development, there is considerable scope for agricultural diversification directed toward home consumption. Much progress has been made in this respect since the first protective tariff was introduced in 1927, but a glance at the list of Cuba's food imports indicates the possibilities that still remain. Agricultural diversification in Cuba has the advantage of utilizing Cuba's cheapest natural resource — her abundant fertile land. Furthermore, the monopoly problem is largely absent from agriculture, since agricultural units usually can operate efficiently on a smaller scale than most industrial enterprises.

However, such small agricultural units require certain external aids which they cannot themselves create, such as roads, storage and marketing facilities, and credit. The establishment of these facilities is largely the business of the government. The responsiveness of agricultural production to such aids would enable the government to promote effectively economic development without direct intervention.

Contrasted with development in the direction of production for the home market is the possibility of investment for exports — both in new agricultural lines and in the processing industries. The great advantage of export activities is their high efficiency, which they must prove continually by meeting the test of international competition. The disadvantage of new export ventures is that they do not reduce Cuba's dependence upon international markets, although they would somewhat curtail the risk by diversifying it. Perhaps this risk could be further reduced by special arrangements to ensure adequate participation in foreign markets, whether through quotas, as in the American sugar market, or through arrangements leading toward a customs union with some of the neighboring Caribbean countries. For some industrial lines, expansion of the



market into a "Greater Caribbean" trade area might be a means of achieving a reasonably efficient scale of production.

### C. GOVERNMENT POLICIES AND BUSINESS ATTITUDES

Among the considerations to be taken into account in evaluating the directions of Cuban developments are certain policies and attitudes of the government, as well as the habits of Cuban entrepreneurs. To the Cuban government belongs the distinction of having been one of the first in Latin America to recognize the importance of diversification. In 1927, shortly after the overexpansion of the sugar industry had begun to be felt, the government introduced a new tariff schedule designed to protect and stimulate a variety of agricultural and industrial activities. The success of this early measure has been considerable, as can be seen by a comparison, for instance, of the proportion of food in total imports during the early twenties and the middle thirties.

Since that time, however, there have been few constructive steps of this sort. The government has acted in the economic field mostly in a regulatory sense. To adapt the sugar industry to the international control schemes, it has organized the industry through the allocation of production quotas for mills and cane growers — in a manner, unhappily, that has weakened the competitive position of the industry by perpetuating the share of the inefficient producers. It has regulated wage scales and employment practices in a form strongly favoring labor and with an unusually strong nationalistic bias. It has intervened in the field of mortgage credit through a series of moratoria. The rationale of all these actions has been distribution, not production. This penchant for redistributing what already exists, instead of creating something new, is of course only too understandable in an export economy where income depends more upon the largess bestowed by the world markets than upon domestic efforts. As for positive constructive action, the main achievement of the government in recent years has been the establishment late in 1948 of a bank of issue, the Banco Nacional de Cuba.

It may be argued that this regulatory, rather than operative,

form of intervention suits the peculiar characteristics of the Cuban government, and that the consequent concentration of economic initiative in the hands of private enterprise promises the best results. There is some evidence to support this view, for Cuban businessmen have shown themselves capable of taking advantage of their opportunities. Nevertheless, the habits of Cuban entrepreneurs still show the traces of a colonial past and to that extent do not greatly aid the development of a more progressive economy. For centuries, large-scale economic activities — with the exception of sugar — have been commercial, not industrial. Today, this predilection for commercial enterprise, which is characteristic particularly of the Spanish-born businessman in Cuba, continues to be strengthened by the relatively greater immunity of commercial operations to government and labor troubles, and by the belief in its quicker and safer returns. The Cuban investor shows the traditional preference for real estate over the anonymous and intangible participation in a corporation, an attitude justified to some extent even today by the inadequate protection that the law extends to minority stockholders. The industrialist, conscious of the limitations of his market and accustomed to seeing high profit rates — even if only occasionally — in the speculative sugar industry, often clings to a “low-turnover high-profit” philosophy of production even for reasonably stable lines, which in turn keeps prices high and further restricts the market. Other impediments to business expansion manifest themselves in the reluctance of family enterprises to admit outsiders, in the unwillingness of some foreign corporations to plow back their local profits and in the all-pervasive “sugar mentality.”

#### D. THE ROLE OF FOREIGN CAPITAL

The foregoing account of some of the circumstances that, in the spheres of government and of private enterprise, stand in the way of more rapid development, suggests that foreign investment can still play an important role in this process. Foreign capital can help in some measure to overcome the shortage of resources that occurs during cyclical upswings and limits

domestic investment.<sup>8</sup> It can help to overcome the effects of the inadequate mobilization of savings, which is reflected in the absence of an adequate capital market and which hampers the promotion of ventures other than by small groups. It can provide ready access to the resources of advanced technology, and it can help to break down some of the inhibitions and obstacles inherent in traditional business psychology and in the "sugar mentality."

Unfortunately, a variety of circumstances have grown up that affect the willingness of Americans to send their capital to Cuba as well as the disposition of the Cubans to welcome its arrival. On the American side the policy announced by the United States government is that private enterprise should take the lead in foreign investment. There still exists, however, the profound disenchantment of the thirties, and this feeling continues to be nourished by the evidence of nationalistic tendencies in Cuba and particularly of unfavorable treatment in labor matters. On the Cuban side, there appears to be a fear of undue foreign influence, particularly as regards direct investment, and a feeling that foreign capital is exploitative. At the same time the view seems to prevail, as elsewhere in Latin America, that the United States will soon be forced to push foreign investment in order to maintain full employment. American capital, it is therefore thought, will eventually become available on easy terms, with the result that concessions to attract capital will prove unnecessary.

It would be very unfortunate if this divergence of viewpoints should create a blockage that would deprive Cuba of the benefits to be derived from capital imports. The main and very great advantage that underdeveloped export economies enjoy is precisely that they do not have to create a modern economy entirely out of their own resources — a process that took

<sup>8</sup> The effective mobilization of the foreign exchange resources accruing at such times, which are the counterpart of the savings simultaneously made out of high export profits, would serve the same purpose as the importation of foreign capital. As a practical matter, however, such policy would probably prove extremely difficult, and moreover not particularly desirable from a cyclical viewpoint, since substantial reserves ought to be accumulated to meet a passive balance of payments later on.

Europe centuries to accomplish. They can borrow capital in amounts far larger and on terms a good deal easier than domestic saving could provide, and they can take advantage of the latest technical innovations without having to go through long and expensive processes of experimentation and obsolescence. Even though such capital may have to be obtained through direct investment and even though the profits to the foreigner may be large, there is no justification for the often prevailing view that all the gains from this investment go abroad. The application of larger amounts of capital to domestic labor is bound to benefit the latter except under conditions of extreme colonial exploitation, which the Cuban government has shown itself quite able to prevent. The very high productivity that capital possesses in the Cuban economy should allow an ample margin within which to seek arrangements satisfactory to both sides.



PART II  
THE DOLLAR YEARS, 1914–1931



## CHAPTER II

### THE MONETARY SYSTEM OF 1914 AND ITS IMPLICATIONS

TO GIVE A CLEAR PICTURE of the trend of events in the evolution of the Cuban monetary system from 1914 to 1947, we shall begin with a brief survey of conditions at the end of this period. At the end of 1947, the Cuban money supply consisted of United States dollars and Cuban pesos, both of which were legal tender. The peso, circulating primarily in the form of silver certificates, was convertible into silver coins at the same rate as the silver certificates issued by the United States Treasury (1.292929 pesos per ounce of silver). Since this rate valued the silver considerably above its market price, the peso had no effective metallic backing. The gold parity of the peso being equal to that of the dollar, the two units exchanged one for one when the peso was at par. As the peso, however, was not convertible into either gold or dollars, the market rate for long periods had deviated from parity, and it was only in the latter part of the war that an exact rate of par came to prevail as a general rule.

Cuba had no central bank and no mechanism for regulating foreign exchange rates. The island's banking system, loosely organized through the Havana Clearing House, had long been dominated by branches of large American and Canadian banks, which controlled the great majority of the system's resources. The banks operated both in pesos and in dollars, but in order to avoid exchange risks they usually were careful to balance their respective positions in each currency.

These are the general outlines of the picture in 1947, the gradual evolution of which we shall trace. The sequence of events, which begins with the establishment of the Cuban peso currency in 1914, falls naturally into two parts. The first ex-



\*tends from that date until 1931, the year preceding the initiation of a new monetary policy. During these eighteen years, the monetary requirements of the country were covered to a constantly increasing degree by the dollar, while the peso, which at that time was almost always at par with the dollar, was virtually driven from circulation. The American and Canadian banks gained control of most of the island's banking business, and Cuba was to all intents and purposes an integral part of the United States currency area. The second period, from 1932 to 1947 was characterized by a growing separation of the Cuban monetary system from that of the United States. The peso currency, issued by the government in increasing quantities for the sake of the seigniorage profit it yielded, for a time practically displaced the dollar in internal transactions. Although the dollar staged a comeback in 1942, after the seigniorage policy had been given up, its ultimate elimination appeared to be only a matter of time.

### I. THE CREATION OF THE PESO CURRENCY

Before the Cuban government established the peso as a new monetary unit in 1914, the island had three types of currency. The dollar was largely employed in transactions with the government, and was also used in foreign trade. The Spanish *centén* (25 pesetas) and the French *luis* (20 francs) predominated in local trade, and various Spanish and French silver coins were used in small retail transactions and for wage payments to country workers unable to insist upon more stable money. The official relation of the dollar to the centen and the luis had been fixed by President McKinley at a rate which slightly overvalued the dollar (\$4.78 for the centen and \$3.83 for the luis) and thus tended to keep the other two currencies out of the tills of the government.<sup>1</sup> In addition to this official rate, there was a second rate which had been established in colonial times by the Spanish government, valuing the centen

<sup>1</sup> These rates were changed to \$4.82 and \$3.86 by President Menocal's Decree 1103 of November 27, 1914. Secretaría de Hacienda, "Legislación Monetaria," *Boletín Oficial* (Havana, 1920), p. 99.

and the luis at 6 per cent above their gold value. The purpose of this overvaluation, equivalent to a devaluation of the Cuban exchange, had been to correct an apparently persistent passive tendency in Cuba's balance of payments, and, probably, to improve the terms of trade for the motherland. Finally there existed a third, commercial rate, based on the actual gold parity of the various coins. The silver coins had no fixed gold parity in private transactions, and their value fluctuated in accordance with the world price of silver. This chaotic situation was a source of handsome profits to the 2,800 exchange houses that were said to operate in Havana in 1915 — and of corresponding losses to the unwary public.<sup>2</sup>

On economic grounds alone, therefore, a reorganization of the currency system was distinctly called for. Nationalistic sentiments may also have contributed to the growing demand for a Cuban currency. In any event, when the conservative party, which apparently had committed itself to monetary reform, was victorious in the presidential elections of 1913, the stage was set for a native Cuban currency. In view of Cuba's close economic and political relations with the United States, it was clear that the reform could not involve an elimination of the dollar as part of the Cuban circulating medium. If Cuba wanted a currency of her own, she had to accept a dual system.

Under these conditions the creation of a central bank of issue would not have been a promising undertaking, since the bank could not have exercised control over the dollar part of the circulation. A more modest project was therefore adopted embodying the following features:<sup>3</sup> The Cuban peso was established as the new monetary unit, with a gold content equal to that of the dollar. The amount of gold pesos that could be coined was unlimited, but in addition silver pesos were to be minted up to an amount of 12 million pesos, with a further quantity of nickel coin at the discretion of the executive. The seigniorage profit on the silver coinage was to pay for the cost

<sup>2</sup> Leopoldo Cancio, in Orestes Ferrara (compiler), "El Problema Monetario de Cuba," *Reforma Social* (Havana, 1915), p. 382.

<sup>3</sup> Law of October 29, 1914, *Gaceta Oficial* (Havana), November 7, 1914.

of recoinng the existing luis and centens into gold pesos. The Cuban gold peso and the currency of the United States were to be unlimited legal tender. All foreign currencies (the dollar, of course, was not regarded as a foreign currency) ceased to be legal tender, but were permitted to continue in circulation, and contracts expressed therein remained binding. Subsequently a decree of September 11, 1915 barred such foreign currencies from all contracts, public or private, and prohibited their importation and circulation except as "merchandise."<sup>5</sup> This decree was later held responsible for subsequent heavy gold exports to Spain, and became the subject of an acid controversy between Secretary of Finance Leopoldo Cancio and Dr. J. A. González Lanuza, a leading politician.<sup>6</sup>

The necessary gold purchases, as well as all other transactions incidental to the coinage process, were not entrusted to the government, but were to be carried out by a local bank under government contract. The law also contained a provision of a very modern flavor, permitting the government to prohibit the exportation of Cuban (not American) money, that is, to establish a partial exchange control. While exchange control in the modern sense was not, of course, envisaged, it is curious to note that in this respect the 1914 law paralleled the legislation recommended to the Cuban government in 1942 by the American Technical Mission.<sup>7</sup>

\*The gold peso was to be minted in denominations of 20, 10, 5, 4, 2, and 1 pesos. The silver coins, which were legal tender only up to amounts of 10 pesos, and beyond that to the extent of 8 per cent of any payment, were to be in denominations of 1 peso, and of 40, 20, and 10 centavos. The somewhat unusual denominations of 40 and 20 centavos were chosen in place of the 50 and 25 cent units current in the United States, because their value equaled that of the one- and two-peseta pieces to which the Cuban public had become accustomed. The silver content of a one-peso coin was fixed at 26.7295 grams, equal to that of the United States silver dollar. The silver content of the 40, 20, and 10 centavo pieces was 10, 5, and 2.5 grams, respectively, the excess of their nominal over their bullion value being somewhat greater than in the case of the one-peso coin. Nickel coins of 5, 2, and 1 centavos were provided for, to be legal tender for payments up to one peso. They were to contain one part of nickel and three parts of copper, and their weights were 5, 3, and 2.5 grams, respectively.

<sup>5</sup> *Gaceta Oficial*, September 14, 1915.

<sup>6</sup> Cancio, in Ferrara, "El Problema Monetario," pp. 369 ff.

<sup>7</sup> "Report to the Cuban Government of the American Technical Mission to Cuba," *Federal Reserve Bulletin* (Washington), August 1942, p. 774.

In accordance with this law, the local banks were invited to submit bids for the coinage contract. The award went to the Banco Nacional de Cuba, and a contract was signed on February 16, 1915.<sup>8</sup> The Banco Nacional undertook to procure gold, have it coined at the Philadelphia mint, and deliver it to the Cuban Treasury, for a commission of one-fourth of one per cent of the total amount involved, plus certain expenses. It also offered the services of its chain of thirty-five branches to aid in putting the new currency into circulation. A second contract was signed on December 15, 1915, under which the Banco Nacional undertook to ship all Spanish and French gold coins received from local banks to the Philadelphia mint for recoinage into Cuban pesos.<sup>9</sup>

The first peso coins arrived in Cuba on April 13, 1915. Further deliveries followed slowly. By the end of 1916 the following amounts had been placed in circulation:

|        |                  |
|--------|------------------|
| Gold   | 23,786,750 pesos |
| Silver | 6,662,000 pesos  |
| Nickel | 755,780 pesos    |
|        | <hr/>            |
|        | 31,204,530 pesos |

Four years later, in 1920, additional silver coins totaling 1,751,140.80 pesos, and nickel coins amounting to 693,780 pesos, were minted, bringing the aggregate peso circulation to 33,649,450.80 pesos.<sup>10</sup> The seigniorage profit to the government amounted to 4,901,649.78 pesos.<sup>11</sup>

## 2. SIGNIFICANCE OF THE MONETARY LEGISLATION

The main virtue of the reform, as said before, was to bring order into the monetary confusion of the island. Otherwise, its scope was quite limited. It did not enable Cuba to pursue an independent monetary policy, but on the contrary had the unintended effect of tying the country even more securely than

<sup>8</sup> Decree 33 of January 12, 1915, *Gaceta Oficial*, January 12, 1915.

<sup>9</sup> "Legislación Monetaria," p. 144.

<sup>10</sup> J. M. Pérez Cubillas and Felipe Pazos y Roque, *El Problema Monetario de Cuba* (Havana, 1940), p. 26.

<sup>11</sup> *Cuba Económica y Financiera* (Havana), May 1939, p. 30.

before into the dollar area. Moreover, the currency chosen by Cuba was almost as expensive, in economic terms, as the foreign gold coins that up to that time had made up most of the circulation. A saving could be realized only on the limited amount of silver coinage permitted, and on whatever volume of subsidiary nickel coin the government was prepared to authorize. Prior to 1932, even these modest economies were not fully exploited, since less than the statutory maximum of 12 million pesos silver was minted. This restraint was motivated by the fear that the silver coins, being valued above their bullion value, might depreciate.

The choice of a monetary unit equaling the value of the dollar deserves some comment. It is obvious that a currency unit should be adapted to the price and income level of the country where it circulates. In this respect the smallest subsidiary unit, in Cuba's case the centavo ( $1/100$  of a peso), is of primary importance, because it is through this unit that marginal adjustments of prices and purchases are made.<sup>12</sup> Since most prices and incomes were lower in Cuba than in the United States, a smaller unit than the centavo would have been required in order to achieve the same accuracy of adjustment which the American cent permitted in the United States. In this sense the centavo and its parent, the peso, failed to meet the requirements of an ideal unit.

Furthermore, if the peso had been given a lower value than the dollar, it might have acquired special functions and might thus have come to dominate in certain fields, as, for instance, in retail trade. As it was, the two currencies became perfectly interchangeable, except for some of the fractional coins, which meant that the gold peso from the start was in danger of being driven out by the dollar bill. This interchangeability, however, while it deprived the peso of any special functions, was in many ways an advantage. It made it unnecessary to accustom the population to a completely new unit, and thus assured a more

<sup>12</sup> The larger the smallest unit, the greater the discontinuity of demand and supply schedules. This is of particular significance for the numerous mass items selling within the range of one to ten of the smallest units.

ready acceptance of the peso currency. Also, it greatly facilitated bookkeeping and the drawing of contracts. Since dollar and peso were both legal tender, contracts usually stipulated for payment in "moneda de curso legal," in order to provide for payment in either currency. The Cuban Treasury repeatedly urged that all contractual distinctions between dollars and pesos be dropped, in order to forestall the possibility that the peso might go to a discount.<sup>13</sup>

Secretary of the Treasury Cancio seems to have cherished the hope that the equivalence of the peso and the dollar would permit the establishment of "monetary reciprocity" with the United States. His thought apparently was that the United States, by way of extending the tariff reciprocity treaty, might give the peso a legal tender status analogous to that occupied in Cuba by the dollar. No serious attempt appears to have been made, however, to initiate such a scheme.<sup>14</sup>

### 3. THE MONEY SUPPLY, 1914-1931

A study of the Cuban money supply, with respect to the causes and magnitude of its fluctuations, is of special interest because of the light that it throws upon the factors governing the level of economic activity. Unfortunately such an analysis is possible only for the period after 1930, since earlier data are inadequate. In this section, we therefore shall confine ourselves to a brief statistical survey which is summarized in Table 1. Additional details concerning the estimates presented will be found in Appendix A.

The main components of the money supply during the period under review were dollar bills and demand deposits. American and Cuban gold and silver coins, as well as subsidiary currency, were also represented. Data on demand deposits are available since 1926. All other components must be estimated. The raw material for these estimates is provided by the Cuban coinage

<sup>13</sup> See circular of April 22, 1915, quoted by Cancio, in Ferrara, "El Problema Monetario," p. 344.

<sup>14</sup> José Miguel Irisarri, *La Moneda Cubana y los Problemas Económicos* (Havana, 1930), p. 34.

figures already quoted, by data on the import and export of dollar bills, and by certain calculations made by the Cuban Treasury.

TABLE 1  
MONEY SUPPLY, 1921-1931<sup>a</sup>  
(In millions)

| End of<br>Year | Gold Coins |       | Silver Coins and<br>Subsidiary Currency |       | Dollar<br>Bills  | Demand<br>Deposits <sup>b</sup> | Total <sup>c</sup> |
|----------------|------------|-------|-----------------------------------------|-------|------------------|---------------------------------|--------------------|
|                | U S        | Cuban | U S                                     | Cuban |                  |                                 |                    |
| 1921           |            | 29.8  |                                         | 11.1  | 102.0            | 80.0                            | 222.9              |
| 1922           |            | 31.0  |                                         | 12.2  | 99.9             | 104.8                           | 247.9              |
| 1923           |            | 31.8  |                                         | 12.6  | 83.0             | 136.7                           | 264.1              |
| 1924           |            | 29.3  |                                         | 12.8  | 84.0             | 157.6                           | 283.7              |
| 1925           |            | 31.2  |                                         | 12.5  | ( <sup>d</sup> ) | 173.6                           | ( <sup>d</sup> )   |
| 1926           | 11.4       | 18.0  | 4.5                                     | 6.7   | 91.7             | 128.3                           | 260.6              |
| 1927           | 9.0        | 18.3  | 1.6                                     | 7.1   | 75.6             | 108.9                           | 220.5              |
| 1928           | 10.6       | 18.4  | 1.3                                     | 7.5   | 63.3             | 131.1                           | 232.2              |
| 1929           | 11.5       | 18.5  | .4                                      | 7.8   | 58.8             | 119.0                           | 216.0              |
| 1930           | 2.2        | 14.8  | 1.1                                     | 7.7   | 38.0             | 97.0                            | 160.9              |
| 1931           | .4         | 11.2  | .6                                      | 7.6   | 39.5             | 73.5                            | 132.9              |

<sup>a</sup> Currency, coin, and demand deposits in the hands of the public and Treasury

<sup>b</sup> Total deposits for the years 1921-1925

<sup>c</sup> Discrepancies are due to rounding. Totals include time deposits for the years 1921-1924

<sup>d</sup> Not available

Sources: Dirección General de Estadística, *Circulación Monetaria y Movimiento Bancario* (Havana), United States Bureau of the Mint, *Annual Report of the Director of the Mint* (Washington), 1921-1924; various publications of the Cuban Treasury

The estimates published by the Treasury for most of the period from 1914 to 1931 are of an extremely uncertain character (see Appendix A). Fortunately, a more reliable method for estimating at least one major component, the volume of dollar bills, is available. This method is based upon the exports and imports of currency reported to the Treasury by the Havana agency of the Federal Reserve Bank of Atlanta and by other banks, and upon the fact that a fairly close estimate can be made of the amount of dollar bills circulating in Cuba at the end of 1929. By cumulating net exports or imports from that date, backwards and forwards, it is possible to derive a series without an excessive probable error.

The estimate for 1929 rests upon the circumstance that during that year the United States shifted from the old, large-size dollar bills to the smaller currency now in use. The old bills circulating in Cuba were withdrawn within a few years by the Atlanta agency, with the coöperation of the banks. The total of these withdrawals, after certain adjustments, should therefore be a fairly close indication of the volume of dollar bills in Cuba immediately before that time.

For the period prior to 1924, the estimates of dollar currency are very uncertain. Likewise uncertain are the data given in Table 1 for deposits before 1926, and for gold coins during the entire period. The remaining items, although subject to similar doubts, are too small to affect the total annual estimates significantly.

Of primary interest in this very scanty picture of the monetary movement is the sharp contraction from a high of 260.6 million in 1926 to 132.9 million in 1931. This, moreover, is only part of the story, for the money supply subsequently continued to shrink, reaching a low of 101.1 million in 1934. The figures illustrate the severity of the monetary pressure to which Cuba was exposed by the depression.

The fact that the contraction began as early as 1926 also is worthy of note. Cuba was already laboring under a depression of her own, caused mainly by declining sugar prices, when the world crisis struck at the end of 1929.

The data do not tell us much about the degree to which the monetary shrinkage was due to a balance of payments deficit and to the liquidation of bank credit, respectively. Bank loans declined from 227.8 millions in 1926 to 135.1 millions in 1931, and to 69.2 millions in 1936. These figures, however, greatly exaggerate the role of bank credit contraction as an element of the total contraction, because they represent in part, not the collection, but the writing off of old loans which had become frozen. (A more detailed discussion of this development will be found in Chapter XI.) The data on the banks' balances abroad, which would be required to supplement the analysis of the causal background of the monetary shrinkage, are not avail-



able prior to 1930. All in all, one may say that although bank credit contraction probably contributed importantly to monetary contraction, the main factor was the passive balance of payments.

#### 4. ECONOMIC IMPLICATIONS OF THE MONETARY SYSTEM BEFORE 1932

The Cuban monetary mechanism, during the period discussed so far, was an outstanding example of a purely automatic system. With the exception of the insignificant fiduciary element in the silver coinages of 1914 and 1920, there was no money creation by the government or by an institution under its influence, such as a central bank.<sup>15</sup>

The volume of the money supply was determined entirely by private bank credit and by the balance of payments. Moreover, with the dollar in circulation, there was no possibility of altering the exchange rate and very little prospect of carrying out an effective exchange control, although before 1931 the latter impediment was without practical importance, since the technique had not yet become generally known.

The economic implications of this automatism are clear. In the first place, Cuba was committed, for better or for worse, to maintaining exchange stability, which in practice meant parity with the dollar, since relations with the United States were always more important than with the rest of the world. In the second place, Cuba forewent the possibility of varying the money supply in accordance with her economic internal situation, but in return was protected against the possibility of mismanagement of its currency. In the third place, the system involved a certain extra cost, since Cuba had to forego some of the savings that could be achieved by creating part of the money supply internally instead of importing it.<sup>16</sup> These three factors of exchange stability, variability of the money supply, and cost of the currency deserve detailed examination.

<sup>15</sup> The coinage of gold pesos merely involved substitution of one type of coin for another, and did not in principle alter the money supply.

<sup>16</sup> This applies only to the currency in circulation.

## A. EXCHANGE STABILITY

The outstanding fact about the dollar circulation was undoubtedly the high degree of secular exchange stability it provided compared with what an independent currency might have offered.<sup>17</sup> Through boom and depression, revolution and moratorium, the dollar gave Cuba an externally stable monetary system with a complete absence of exchange difficulties. While this unconditional stability was in many respects an advantage, because of the confidence it inspired and the problems which it eliminated, it may have been a handicap at times when a flexible exchange policy could justifiably have been advocated. There were one or two such occasions when exchange depreciation deserved serious consideration (see Chapter XIII).

On the other hand, it may be argued that in the face of existing political and economic problems, any attempt to manipulate an autonomous currency would have been bound to fail, and that the dollar saved Cuba from monetary chaos. During the early twenties, moreover, the specter of American intervention still was very much in the foreground, and monetary disorder in Cuba might have been regarded as falling under the provisions of Article III of the Platt Amendment, which permitted the United States to intervene in Cuba for the preservation of property rights and financial stability. In view of the difficulties that many Latin American countries have experienced in making their exchange-rate manipulations fruitful rather than self-defeating, a fairly strong case can be made by those who believe that Cuba was fortunate to have had her hands tied in this respect.

The fact that dollar bills rather than a local unit rigidly tied to the dollar were in circulation is not, of course, the essential element in this situation. A local unit tied to the dollar by means of a rigid conversion mechanism would have offered the same stability and would have produced the same monetary

<sup>17</sup> Owing to the closeness of economic relations between Cuba and the United States, exchange stability for Cuba really means stability vis-à-vis the dollar. From the Cuban viewpoint, therefore, the dollar depreciation of 1933 did not imply exchange depreciation in any but a very limited sense.

effects. It is highly unlikely, however, that such a mechanism would have survived the pressures of the period. The outstanding characteristic of the dollar in Cuba was precisely that it could be neither stretched nor bent. In this sense businessmen are right when they speak of the dollar circulation in Cuba as a great confidence-creating element.

#### B. VARIABILITY OF THE MONEY SUPPLY

The absence of a central bank or other mechanism for the issuance and independent regulation of the money supply made Cuba dependent upon private-bank lending and upon the automatic money-creating processes of the balance of payments. While these processes in the long run tend to be self-adjusting, an excess or deficiency setting in motion forces that eventually would correct either condition, such adjustment is slow and often involves passing through extreme phases of insufficient or excessive liquidity which are apt to be very harmful.

On the side of insufficiency, trouble may arise in the form of (1) insufficient elasticity during a seasonal or cyclical expansion, (2) wide-spread insolvency during a crisis, and (3) lack of appropriate stimulation during a cyclical contraction. On the side of excess, an automatic system like the Cuban might be guilty of (1) producing an inflationary boom, and (2) permitting excessive monetary ease during times of contraction, leading to an undesirable outflow of funds.

In the United States, prior to the creation of the Federal Reserve System, the main dangers in connection with a monetary insufficiency arose from a lack of elasticity to meet expansion, and the absence of a lender of last resort in times of crisis. In Cuba, these dangers were not present. The balance of payments involved such large totals, relative to the total volume of business on the island, that rapid changes in the money supply could take place to meet the needs of expansion. Moreover, if the ordinary processes of the balance of payments should prove insufficient in such a case, the foreign banks could draw upon their head offices, since such borrowing involved no exchange risk. The availability of head office support also did away with the need for a lender of last resort for the foreign banks, which

after 1921 constituted the bulk of the Cuban banking system. It must be added, however, — anticipating the events related in the next chapter — that it was precisely the absence of a lender of last resort that caused the collapse of most of the native Cuban sector of the banking system in 1920.

On the other hand, Cuba suffered gravely from the third type of monetary insufficiency, the absence of stimulating money creation during depression. If the banks could not or would not lend, there was no central bank which directly or through the government could fill the gap. Deflation had to be allowed to run its course, with consequences which eventually proved very painful to the Cuban economy. This is illustrated by the drop in the money supply from 260.6 million in 1926 to 101.1 million in 1934, as shown in Tables 1 and 4.

On the side of monetary excess, we find an analogous picture. The danger of an undesirable monetary ease in depressions did not constitute a major problem in a country where the real danger was extreme deflation. But the possibility of monetary excesses during a boom was a very real one. From 1934 to 1947, the Cuban system produced an expansion of the money supply of 518 per cent, and although these data relate to a period subsequent to that here discussed, when the monetary mechanism had changed somewhat, they are valid as an illustration. Naturally such an expansion can, and in fact did, give rise to considerable price inflation.

Even a cursory examination indicates, therefore, that insofar as the Cuban monetary mechanism failed to maintain the money supply at proper levels, its defects were those of excessive variability rather than of sluggish response. This is true despite the fact that the money supply rested on only one layer of fractional reserves — those of the commercial banks — instead of on two, as in countries with a central bank. The high variability is explained, however, by the relative size of balance of payments fluctuations and by the free flow of funds between the foreign banks and their head offices.

Evidently the mechanism was far from perfect as a regulator of the money supply. To the question of whether an independent currency, with proper instruments of monetary control,

would have been preferable, much the same answer must be given as to the question of a flexible exchange rate — that it depended upon the management. Certainly there have been occasions when a well-managed monetary system could have done a great deal for Cuba, while the automatic processes dragged the island mercilessly through the ups and downs of the cycle. But the difficulties of proper management are very great, as the experience of other Latin American countries has shown, and failure can be far worse than any automatism.

Without going into the details at this point of monetary management problems and their relation to the cyclical pattern which dominates the Cuban economy, one obvious aspect may be pointed out. Monetary management in Cuba would be preferable to an automatic mechanism only if it serves to reduce the elasticity of variability of the money supply, not to increase it. This purpose is in many ways the opposite of the original conception underlying central banking operations in the United States and many other countries, which was that of increasing the elasticity of the money supply.<sup>18</sup> Such a difference in viewpoint follows inevitably from the structural diversities of the respective economies. In Cuba, a typical export economy, where the balance of payments tends to be active during the upswing of a world-wide cycle and passive during the downswing, the liquidity of the banking system and of the entire economy tends to increase during the upswing and to diminish during the downswing. This cyclical pattern, contrasting strikingly with that which has prevailed, with some exceptions, in Britain and the United States, has numerous important consequences for monetary institutions and policy which will occupy us throughout most of Part IV of this book. For the time being, it is sufficient to point out that in Cuba any additional variability injected into the money supply by a central bank would have aggravated rather than cured the evils inherent in the automatic mechanism. This conclusion is applicable not only to the monetary mechanism existing prior to 1932, but also to its modified variant of 1947.

<sup>18</sup> A conception which later yielded to a flexible anticyclical philosophy

## C. THE COST OF THE CURRENCY

A feature of the Cuban monetary system which has frequently been commented upon was the high economic cost of the currency.<sup>19</sup> Cuba's entire circulation (with the exception of the fiduciary element in the small silver and nickel circulation) was the product of her balance of payments on current or capital account, which means that an equivalent amount of resources had been surrendered in obtaining it. If money entered because of an export surplus, these exports constituted the payment, and if it was acquired as the direct or indirect result of foreign loans or investments, payment for it was made in the form of interest, bank profits, or dividends. The Cuban currency thus was the equivalent of a pure gold currency.<sup>20</sup> Since in Cuba the volume of currency was of the same order of magnitude as that of demand deposits, a very substantial part of the money supply suffered from this high-cost aspect. It may be added, incidentally, that even in the case of money created through bank credit, the Cuban economy did not save much, despite the fiduciary character of this part of the money supply. Since most of the banks were foreign owned, the profits from money creation largely went abroad.

It has often been assumed implicitly that by issuing a currency of her own, Cuba could substantially reduce the cost of her currency. This view, however, rests upon an incomplete and over-optimistic appraisal of Cuban monetary conditions. A more searching examination will show that what appears as the cost of the dollar currency is basically in large part a burden imposed upon Cuba by the fact that hers is a highly unstable export economy in which large foreign interests are represented. The form in which this burden happened to manifest itself

<sup>19</sup> See Frank D. Graham, in Foreign Policy Association, Inc., Commission for the Study of Cuban Affairs, *Problems of the New Cuba* (New York, 1935), pp. 320 ff.

<sup>20</sup> By using dollars, Cuba was in effect making a loan to the United States. The "withdrawal" of this loan, however, which could have been effected by presenting the notes for redemption and importing gold into Cuba, would not have made the currency any cheaper.

during the period before 1932 was merely the result of the particular institutional arrangements then existing. A change in these arrangements might have altered the form, but probably would not have greatly affected the intrinsic weight of the burden.

The currency of a young and relatively unstable country obviously does not ordinarily enjoy the confidence inspired by well-established key currencies like the dollar or, in normal times, sterling. In such a country, there is likely to be a tendency among holders of surplus funds to convert these into balances in some stronger currency. For many foreigners, and for corporations capitalized abroad, preference for their home currency is an invariant policy. They must, of course, hold a certain volume of local currency for working purposes, but holdings beyond this amount to them signify exchange speculation. Such a risk normally is alien to their business and is generally avoided, if exchange regulations permit.<sup>21</sup>

While the dollar was firmly entrenched in Cuba, this problem did not arise there. The banking system, after the disappearance of most of the native banks, was composed almost entirely of branches of banks that ranked among the largest in the world. Under these circumstances, the funds which, in the case of another country, would have been held abroad, could safely remain in Cuba, where they served to increase the circulation, directly or through the intermediary of the banks. Had a fiduciary currency been introduced and the legal tender status of the dollar been abolished, however, it is fairly certain that idle funds of many American and other foreign corporations would not have been converted into pesos, but would have been transferred abroad. Native Cuban capital probably would likewise have emigrated in substantial amounts. To the extent that capital flight was engendered, the economies anticipated from the establishment of a fiduciary currency thus would have failed to materialize. In other words, the cost of that part of the dollar circulation which would have left the country after the estab-

<sup>21</sup> The carrying of balances abroad is, of course, a form of capital export, which an undeveloped country can ill afford, but which it cannot prevent without resorting to very rigid exchange control.

lishment of a fiduciary currency was not an avoidable one. One cannot tell, of course, what proportions the flight of capital might have assumed. If the withdrawals following the establishment of a pure peso circulation had left just enough dollars in Cuba to provide a monetary reserve for the issuing institution, Cuba's gain from the new currency would have been zero.<sup>22</sup> If more dollars were left, there would be a profit; if fewer dollars, a loss.

The following example may serve as an illustration. Let us assume that the Cuban currency circulation consists of 75 million dollars, and that bank deposits total 125 million dollars, against which the banks hold dollar reserves of 25 million. Let us further assume that the Cuban government decides to replace these 100 million dollars in circulation and in the banks with an equal amount of pesos, through the medium of a central bank. As a reserve against notes and member bank deposits, the central bank is to hold 50 million dollars, the balance to be covered by an equal amount of Cuban government securities. The government then deprives the dollar of its legal tender character and offers to exchange the existing dollar bills against pesos. In this way it hopes to absorb 100 million, of which 50 million will form the central bank reserve, while the other 50 million will be used to pay off, say, part of Cuba's foreign debt. The holders of dollar bills and deposits, however, do not want to carry all their funds in pesos. Let us assume that they regard one-fourth of their cash and deposits as surplus funds not needed in daily operations. They therefore decide to transfer 50 million dollars to New York banks. The Cuban banks employ part of their reserves to make the transfer and obtain the remainder partly from currency paid in and partly through rediscounts with the central bank. A total of 50 million dollars in bills is shipped to New York. The central bank retains the other 50 million. Cuba now has a currency only half as "costly" as the old one, but she has been unable to realize any gain from the transaction.

<sup>22</sup> A small offsetting item might have appeared in the form of interest earned abroad and repatriated by Cuban capitalists, including such interest as the issuing institution might have earned by investing part of its monetary reserve in foreign markets.



If the government were to establish strict exchange control before undertaking the currency reform, it might be able to prevent the exodus of idle funds until complete confidence in the new money had been established, an end which under exchange control is not likely to be accomplished very soon. It is clear that this procedure probably would not be worth the economic cost.

The answer to complaints regarding the high cost of the Cuban currency during the twenties, therefore, is this: It is true that the currency was expensive; it is an error, however, to think that Cuba could have avoided all of this cost by adopting a fiduciary currency of her own. The cost is one that arises very largely out of Cuba's fundamental economic position, and it is probably one of the least important among the various costs which that position implies.

One cannot, of course, assess the dollar-and-cents value of this cost, but an estimate of its order of magnitude may perhaps be made. The result depends not only on the aggregate circulation and the prevailing interest rate, but also on the size of the reserve which the agency issuing the new fiduciary currency is assumed to hold. In view of the extreme fluctuations to which the Cuban economy is exposed, the reserve naturally would have to be high. Between December 31, 1924, and December 31, 1931, Cuba lost, of her total supply of gold and dollars aggregating 169.1 million dollars, a net amount of 105.2 million in dollar bills, gold coin, and subsidiary currency (Table 17). In 1924, therefore, the hypothetical monetary authority would have required an initial reserve of considerably more than 105.2 million in order to maintain exchange stability throughout.<sup>23</sup> There remains a maximum of 63.9 millions which hypothetically could have been absorbed by the government for debt repayment or similar purposes, and the interest on which may, in a sense, be regarded as constituting the opportunity cost of the dollar circulation. As a practical matter, however, only part, if any, of this cost was avoidable, for the displacement of the

<sup>23</sup> Barring foreign loans or exchange control, and also barring a policy of domestic contraction beyond even the extreme degree of deflation prevailing in 1931.

dollar by a Cuban fiduciary currency would undoubtedly have been followed by heavy exports of capital. Only to the extent that these exports had remained below 63.9 million could a saving have been achieved through the creation of a fiduciary currency.

Given the fact that on December 31, 1924, the deposits of reporting banks amounted to only 157.6 million, and that prospects for the 1925 sugar crop were good, one may perhaps venture to guess that if a fiduciary currency had been established then, the outflow of funds would, with luck, have been less than 63.9 million. Let us assume an outflow of only 15 per cent of the 283.7 million that represented the aggregate of deposits and currency and coin in circulation, that is, an outflow of 42.6 million over and above the amount that ought to have been set aside as a central bank reserve. The government would then have realized from the conversion a sum of 21.3 million. Assuming that with these funds the government had redeemed an equal amount of its foreign debt, bearing 5 per cent interest, it would have effected an economy of 1.1 million dollars, representing little more than 1 per cent of its total budgetary expenditures, and a much smaller proportion of Cuba's national income. It is evident that, whatever the merits and demerits of the dollar circulation, the cost element is not a major consideration.

## CHAPTER III

### THE BANKS, 1914-1931

#### I. CHARACTERISTICS OF THE BANKING SYSTEM

THE SIZABLE GROUP of large and small banks that existed in Cuba at the end of the First World War did not form a cohesive banking system and operated practically without legal controls. The absence of a central bank was of course a common feature in Latin American countries, but Cuba was also without effective banking legislation. There were provisions for the examination of credit institutions through the Department of Agriculture, Commerce, and Labor, but during the liquidation of the banks which failed after 1921 it was found that none of them had ever been inspected.<sup>1</sup> The Commercial Code of 1886 stipulated that banks were to carry 25 per cent reserves against their deposits, but no penalties were imposed for violations of this rule, nor were means at hand for determining whether reserve requirements were being met regularly.<sup>2</sup> No control was exercised over the creation of new banks, the sole requirement being their inscription in the Commercial Register, and of course there was no control over their operations. The meteoric career of the Banco Internacional, whose rise and subsequent collapse were equally spectacular, illustrates the potentialities of such a situation.

The number of banks operating in Cuba at the time of the First World War cannot be stated with any exactitude, because an accurate dividing line between banks, merchant bankers, and exchange houses cannot be drawn. The *Rand McNally Bankers Directory* mentions twenty-eight names, but there are some ob-

<sup>1</sup> Comisión Temporal de Liquidación Bancaria, *Compendio de los Trabajos Realizados* (Havana, 1928), p. 16.

<sup>2</sup> *Ibid.*

vious omissions.<sup>3</sup> The oldest institution was the Banco Español de la Isla de Cuba, which had been founded in 1856 under the name of Banco Español de la Habana. On December 31, 1914, it had a capital and surplus of 8.0 million pesos, deposits of 20.1 million, and total resources of 31.8 million. Its business was chiefly with the Spanish colony in Cuba, whose members predominated in retail trade.

Leading in terms of total resources was the Banco Nacional de Cuba. It was founded in 1901 with a capital of one million dollars and had taken over the business of the North American Trust Company. Like its predecessor, it became fiscal agent for the occupationary government, and subsequently for the Cuban government. Its activities in connection with the coinage of the Cuban currency have already been mentioned. In 1914 it had a capital and surplus of 6.9 million pesos, deposits of 23.7 million, and total resources of 32.7 million.

Second to these two institutions were the branches and subsidiaries of large American and Canadian banks. The oldest of these was the Royal Bank of Canada, which in 1899, when it was still the Merchants' Bank of Halifax, had entered Cuba by taking over the Banco de Comercio. The Cuba Trust Company was founded in 1905 with American capital and management. The National City Bank began to open branches in 1914. The Bank of Nova Scotia had entered the scene in 1901. Among the larger private banking firms in Cuba may be mentioned N. Gelats and Company and H. Upmann and Company.

It is to be noted that neither the Banco Nacional nor the Banco Español, though commonly referred to as "domestic banks" in contrast to the branches of foreign banks, can unqualifiedly be regarded as native Cuban institutions, if the nationality of the managers and owners is made the criterion. The Banco Nacional had evolved out of the North American Trust Company, a wholly American institution; its president, W. A. Merchant, was an American, and its internal correspondence was in English.<sup>4</sup> In the course of the years, a bare majority of its stock (25,001 shares out of 50,000) had passed into the

<sup>3</sup> *Rand McNally Bankers Directory* (Chicago), July 1915.

<sup>4</sup> *Comisión Temporal, Compendio*, 1928, p. 103.

hands of José López Rodríguez, a resident of Cuba of Spanish nationality.<sup>5</sup> As to the Banco Español, it was believed that its owners were chiefly among the members of the Spanish colony in Cuba, and its shares were also traded on the Paris stock exchange.<sup>6</sup>

The essential fact about these institutions was, however, that their policy, in contrast to that of the branches of American and Canadian institutions, was determined locally, and that their interests were closely identified with those of the Cuban economy. For this reason it seems entirely fair to regard them as domestic institutions. In the following, they will therefore be referred to as "domestic banks," while for the American and Canadian branches the term "foreign banks" will be used. The two groups jointly will be referred to as the "Cuban banks."

## 2. BOOM AND CRISIS, 1920-21

The increase in Cuban business activity during the First World War led to the establishment of various new banks and greatly expanded the resources of the older institutions. The Banco Internacional, of purely Cuban origin, opened for business in December 1917 and quickly built up a string of 105 branches, second only to the 112 branches which marked the maximum expansion of the Banco Nacional. The Banco Mercantil Americano de Cuba, incorporated in 1918, operated under the auspices of the Mercantile Bank of the Americas in conjunction with the Guaranty Trust Company, Brown Brothers, and J. and W. Seligman and Company. The American and Foreign Banking Corporation, controlled by the Chase National Bank, opened a branch in Havana in January 1919.<sup>7</sup>

From the balance sheets of the Banco Nacional and the Banco Español (see Table 2) it will be seen that prior to 1920 the rate at which the older banks expanded their business was rapid but not exorbitant. During the first half of 1920, however, total assets of the Banco Nacional increased by 66 per cent and those of the Banco Español by 33 per cent. This jump was the

<sup>5</sup> *Ibid.*

<sup>6</sup> *Ibid.*

<sup>7</sup> *Federal Reserve Bulletin*, November 1920, p. 1167; Leland H. Jenks, *Our Cuban Colony* (New York, 1928), p. 213.

result of the famous sugar boom which followed upon the abandonment of control over sugar prices, previously exercised through the American Sugar Equalization Board. From a price of 5.5 cents per pound, which was paid by the Board for the 1918 crop, Cuban sugar rose to 9 cents in February 1920, 15 cents in April, and reached a peak of 22.5 cents on May 19. Although only a small amount of sugar was sold at top prices, and although the 1920 crop was smaller than the preceding one, the total value of the 1920 crop was calculated at 999.9 million pesos, against 454.5 million in 1919.

An increment of more than 100 per cent in the value of the sugar crop required a correspondingly greater volume of financing. Sugar producers and speculators absorbed large amounts of credit. But what inflated bank assets and liabilities was not sugar financing alone. The sugar boom plunged all of Cuba into an orgy of prosperity and speculation, the "Dance of the Millions" of unhappy memory. All values became inflated and properties were changing hands rapidly. The process of concentration in the sugar industry, which had been going on for some time, was accelerated, and it is reported that fifty mills, more than one quarter of the 198 existing in Cuba, were acquired by new owners in 1919 and 1920.<sup>8</sup> New enterprises were being started recklessly, and existing ones were absorbed by would-be empire builders. Cuban industrialists and cane planters built sumptuous houses and devised other more ingenious forms of luxury spending. For all this the banks were glad to lend the necessary money.

The Banco Nacional became deeply involved in the speculations of its majority stockholder, López Rodríguez, one of whose earlier exploits had been the purchase of the bank's stock with loans from the same institution. The Banco Español went heavily into promotional ventures, as can be seen from the rapid growth of the item "stock and bonds" on its balance sheet, an item which reached 18.9 million pesos in June 1920. The Banco Internacional, in the attempt to build itself up to the size of the older banks, established branches without regard to permanent profitability and lent money with more enthusiasm

<sup>8</sup> Jenks, *Our Cuban Colony*, p. 221.

than discretion.<sup>9</sup> Thus, while the portfolios of the various institutions became fairly well diversified, the value of each class of assets was dependent upon the sugar boom which could last only as long as the price of the commodity remained at previously unheard-of levels.

It will be noted that the cash position of the Cuban banks, as of June 30, 1920, appeared to be exceptionally strong. The ratio of cash to deposits was 46.8 per cent for the Banco Nacional, 45.9 per cent for the Español, and 52.3 per cent for the Internacional. In appraising these ratios it must be remembered, however, that in June the volume of sugar financing is close to its seasonal low. The cash item, moreover, includes checks on other banks, which points to a certain amount of window dressing.<sup>10</sup> It will be noted that the statements show no evidence of excessive borrowings from other banks, as indicated by the items "credits in current account" and "due to banks and bankers," which amounted to 1.4 million pesos for the Nacional, 0.5 million for the Español, and 1.3 million for the Internacional. There is, however, no assurance that additional borrowings were not disguised under some other heading. Furthermore, since these obligations had been considerably larger on earlier dates, it is not unthinkable that their relatively low level as of June 30, 1920, resulted from previous withdrawals of credit by the lending banks and therefore reflected a somewhat strained position of the Cuban banks even at that time, in spite of their apparent liquidity.

The statements of the foreign banks, of which only the Na-

<sup>9</sup> Comisión Temporal de Liquidación Bancaria, *Compendio de los Trabajos Realizados desde el 17 de Febrero 1921 hasta el 4 de Agosto 1924* (Havana, 1924), p. 117.

<sup>10</sup> In the case of the Banco Nacional, where a more detailed balance sheet is available, cash in vault amounted to only 40.7 million pesos, while deposits with other banks accounted for 31.3 million, and transit items for 19 million. In the case of the Banco Español, strong evidence of window dressing is provided by the fact that the balance sheet of June 30, 1920, as compiled by the bank's liquidating committee, shows net cash of 19.6 million pesos, as against 51.5 million reported in the published statement. See *Memoria de la Liquidación del Banco Español de la Isla de Cuba* (Havana, 1926), p. v. The same source shows total assets on that date at 89.2 million pesos, against 125.9 million in the published statement, and 94.5 million mentioned in Comisión Temporal, *Compendio*, p. 113.

tional City Bank's statement is reproduced, all show very small cash holdings, but likewise reflect an insignificant volume of deposits, except in the case of the National City Bank, and substantial borrowings from their head offices. Since the great resources of the head offices stood back of the liabilities of their Cuban branches, the balance sheets of the latter give little ground for criticism with respect to liquidity.

The price of sugar reached its peak on May 19, 1920, and then began to decline. By the end of June it had dropped to  $17\frac{1}{4}$ , at the end of July it was  $15\frac{1}{4}$ ; and at the end of August, 11 cents per pound. Other storm clouds began to gather. Cuban importers, who had pyramided their orders in the United States when supplies were hard to get, suddenly found themselves faced with a larger volume of deliveries than they had expected or could pay for. A severe congestion of the port of Havana developed, which caused further difficulties and losses. In August the New York banks began to call in loans from their Cuban correspondents, who had been restricting their own lending as early as June.<sup>11</sup> Press campaigns were started against individual banks, particularly the Banco Español,<sup>12</sup> whose shares began to fall.<sup>13</sup> The situation of all banks became progressively tighter, but up to the last moment there was little coöperation among the various institutions. The Banco Español was subjected to heavy withdrawals in the early days of October, which culminated on Saturday, October 9, when 9 million pesos were paid out during the brief banking hours of that day.<sup>14</sup> The Banco Nacional, although in somewhat better condition, was unable to help, the Internacional was close to the end of its own resources, and on the following Monday, October 11, President Menocal, following the request of the bankers, declared a moratorium.

The moratorium decree provided that debts evidenced by credit instruments, such as notes, drafts, and mortgages, and so forth, falling due before December 1, 1920, were to remain in suspense to that date. Within this period, bank depositors could

<sup>11</sup> Comisión Temporal, *Compendio*, 1928, p. 29.

<sup>12</sup> Jenks, *Our Cuban Colony*, p. 230.

<sup>13</sup> Comisión Temporal, *Compendio*, 1928, p. 29.

<sup>14</sup> *Ibid.*





TABLE 2 (Continued)

| BANCO INTERNACIONAL               |               |               |               |               |               |               |               |
|-----------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
|                                   | Dec 31, 1914  | Dec 31, 1915  | Dec 31, 1916  | Dec 31, 1917  | Dec 31, 1918  | Dec 31, 1919  | June 30, 1920 |
| Assets                            |               |               |               |               |               |               |               |
| Cash and cash items               | .....         | .....         | .....         | .....         | 2.9           | 8.0           | 19.2          |
| Loans and discounts               | .....         | .....         | .....         | .....         | 4.6           | 14.6          | 22.1          |
| Stocks and bonds                  | .....         | .....         | .....         | .....         | .1            | 1.2           | 1.3           |
| Other                             | .....         | .....         | .....         | .....         | 1.2           | 3.1           | 4.6           |
| Total                             | .....         | .....         | .....         | .....         | 8.8           | 26.9          | 47.2          |
| Liabilities                       |               |               |               |               |               |               |               |
| Capital                           | .....         | .....         | .....         | .....         | 1.0           | 5.0           | 5.0           |
| Deposits                          | .....         | .....         | .....         | .....         | 6.6           | 18.9          | 36.7          |
| Credits in current account        | .....         | .....         | .....         | .....         | .4            | .8            | 1.3           |
| Other                             | .....         | .....         | .....         | .....         | .8            | 2.2           | 4.2           |
| Total                             | .....         | .....         | .....         | .....         | 8.8           | 26.9          | 47.2          |
| NATIONAL CITY BANK <sup>a</sup>   |               |               |               |               |               |               |               |
|                                   | June 30, 1914 | June 30, 1915 | June 30, 1916 | June 30, 1917 | June 30, 1918 | June 30, 1919 | June 30, 1920 |
| Assets                            |               |               |               |               |               |               |               |
| Cash and cash items               | .....         | .....         | .....         | .....         | 1.2           | 3.4           | 5.6           |
| Loans and discounts               | .....         | .....         | .....         | .....         | 7.5           | 26.2          | 56.1          |
| Due from home office              | .....         | .....         | .....         | .....         | .0            | .0            | .0            |
| Other                             | .....         | .....         | .....         | .....         | .4            | 7.5           | 11.9          |
| Total                             | .....         | .....         | .....         | .....         | 9.1           | 37.1          | 73.6          |
| Liabilities                       |               |               |               |               |               |               |               |
| Capital and undistributed profits | .....         | .....         | .....         | .....         | 1.2           | 1.3           | 1.6           |
| Deposits                          | .....         | .....         | .....         | .....         | 6.7           | 12.3          | 29.4          |
| Due to home office                | .....         | .....         | .....         | .....         | .9            | 14.3          | 33.7          |
| Other                             | .....         | .....         | .....         | .....         | .3            | 9.2           | 8.9           |
| Total                             | .....         | .....         | .....         | .....         | 9.1           | 37.1          | 73.6          |

**\* All branches in Cuba.**

Source *Federal Reserve Bulletin*, November 1920, pp. 1166-68.

withdraw no more than 10 per cent of their balances, except in the case of savings accounts below 2,000 pesos, where 12 per cent was permitted. The government protected its own interests by allowing depositors to draw on their balances for the payment of taxes, customs duties, and other dues, and by declaring the moratorium inapplicable to the Banco Nacional with respect to its fiscal agency functions.

### 3. CONSEQUENCES OF THE MORATORIUM

The chief, and perhaps sole, merit of this decree was to prevent the immediate collapse of some of the larger and many of the smaller banks, which otherwise probably would have been inevitable. On the day of the moratorium, the Banco Nacional had cash resources of only 22.8 million pesos,<sup>15</sup> against 91 million on June 30. It might therefore have been able to resist the run for a few days more, but could not have continued payments if withdrawals had lasted longer. Compared with the Banco Español, however, its position was almost comfortable, for the Español's cash had been reduced from a stated 51.5 million pesos on June 30 to 5.6 million, whereas its deposits still amounted to 72.4 million. The bank obviously could not have held out another day.

But while the moratorium decree saved the banks for the moment, it did nothing to prepare the way for a resumption of payments, and in fact opened the door to a number of abuses which, together with the losses sustained, eventually forced most banks into liquidation.

In the first place, the moratorium protected not only the banks, but most of their debtors as well, and thus made it difficult for the banks to call in their loans and improve their cash position. It is true, of course, that the freezing of bank accounts rendered it necessary to extend some form of protection to debtors whose cash balances were thus immobilized. In many cases, however, the nonbank debtors were more fully protected than the banks themselves, for the latter at any rate had to provide for payment of up to 10 per cent of their deposits. Thus, even if everything else had been well, the banks could

<sup>15</sup> *Ibid.*, p. 106.

have accumulated cash only at a slow rate, and their condition was not likely to improve radically before the expiration of the moratorium.

Under the moratorium, however, everything else was far from well. The first obvious loophole was the clause permitting withdrawals for payments of dues to the government. Most depositors who owed customs duties, taxes, or other debts to the government, or were able to make a pretense of having such obligations, immediately took advantage of this clause to salvage part of their balances. So large was the amount of funds which escaped in this manner that only ten days after the original decree, on October 21, the authorities were forced to announce that payments to the government were not to exceed the 10 per cent limit allowed each depositor.<sup>16</sup> By that time, however, many accounts had been reduced by much more than 10 per cent.<sup>17</sup>

At the same time, the dangerous practice of trading in certified checks was beginning to spread among the domestic banks. Although the moratorium made it illegal for depositors to withdraw more than 10 per cent of their balances, there was nothing to prevent them from writing out checks, having them certified, and selling them at a discount in the curb market which soon developed for this type of paper. Depositors who needed money, or who were sufficiently skeptical about the future of their banks, found this a quick, though painful, means of converting part of their frozen accounts into cash.<sup>18</sup>

Purchasers of certified checks used these to repay loans owed to the banks upon which the checks were drawn, or to purchase properties which the banks had acquired through the execution of secured credits. From a purely bookkeeping angle, these "compensations," as they were called, looked perfectly proper. The bank "liquidated" an asset and thereby reduced its deposit

<sup>16</sup> *Gaceta Oficial*, October 22, 1920.

<sup>17</sup> Comisión Temporal, *Compendio*, 1928, p. 31.

<sup>18</sup> In 1923, after the situation had deteriorated considerably, checks on the Banco Nacional sold for about 40 per cent of face value, while those on the Banco Internacional brought only one per cent. See Bureau of Foreign and Domestic Commerce, *Economic Conditions in Cuba*, Trade Information Bulletin No. 159 (Washington, 1923), p. 8.

liabilities, both sides of its balance sheet shrinking by the same amount. In fact, however, compensation was a device by which still solvent debtors could escape part of their obligations, to the detriment of depositors and stockholders. The loans which were compensated with certified checks, bought at a discount, were largely the sound ones, which otherwise would frequently have been paid off in cash, even though the bank might have had to wait a little longer. By accepting compensations, the banks were able to reduce their liabilities very rapidly, but without receiving much cash and at the cost of a progressive deterioration of their portfolio. This deterioration caused a gradual fall in the market value of certified checks, which in turn permitted even weaker debtors to compensate and left the domestic banks with only the worst types of assets.

One may ask why bankers consented to compensations which obviously did not aid them in regaining their solvency. Favoritism toward well-connected debtors undoubtedly was part of the answer. In many instances, the directors themselves were among the most heavily involved. In other cases, however, the practice was not without justification. Cash payment was hard to obtain, not only because of the continuance of the moratorium, but more particularly because of the depressed condition of the sugar industry. The opportunity for cheap repayment induced debtors to make sacrifices in order to liquidate loans which they otherwise would have been unwilling or unable to settle. In such cases, the banks may have been wise in taking payment in depreciated checks rather than run the risk that the loans would become completely uncollectible.<sup>19</sup>

Originally, there seems to have been some doubt about the legality of compensations. Under Cuban law they were permissible, but only subject to certain conditions which did not prevail under the moratorium.<sup>20</sup> They received congressional sanc-

<sup>19</sup> The policy of the Banco Español was to reject an offer of immediate compensation if cash payment within two months could reasonably be expected. Where the probable delay was greater, the risk was considered excessive and compensation was accepted. See *Memoria de la Liquidación del Banco Español*, p. 26.

<sup>20</sup> Commerce, *Economic Conditions in Cuba*, p. 7. According to García, they were not legal. See Comisión Temporal, *Compendio*, 1928, p. 48.

tion in the second Torriente law of January 27, 1921, but were later curbed by order of the Temporary Commission.<sup>21</sup> Under this order no further compensations of credits secured by mortgages, or by liens on commodities (*créditos pignoratícios*), were permitted after May 5, 1921. Other compensations, with certain exceptions, were restricted to single name credits not exceeding 10,000 pesos. By that time, however, most of the damage had already been done. Its extent is illustrated by the fact that as early as April 11, 1921, the Banco Nacional alone had compensated loans amounting to approximately 60 million pesos.<sup>22</sup>

In view of the conditions created by the moratorium and of the abuses which it invited, it is not surprising that on December 1, the date on which it was to expire, most of the domestic banks were in no position to resume payment. The sugar market, moreover, had not reversed its downward trend, and sugar speculators still were faced with execution of their credits and loss of their equity as soon as protection was withdrawn. The moratorium was therefore extended first to December 31, 1920, and later to January 31, 1921.<sup>23</sup>

Meanwhile, a number of schemes were being discussed to clear up the intolerable situation, which threatened not only the existence of the banks and of numerous sugar interests, but also the solvency of the Cuban government. One suggestion was to put the banks back on their feet by means of a central bank. Another plan involved the issue of legal tender certificates by the banks, redeemable within a year and secured by "approved securities."<sup>24</sup> A third proposal, submitted by Albert Rathbone, former Under Secretary of the United States Treasury and at the time financial adviser to the Cuban government, contemplated a large loan to the government to save the banks, without attempting to bail out the sugar interests.<sup>25</sup> Finally, there was talk of a broad program to buy up the remainder of the

<sup>21</sup> Comisión Temporal, *Compendio*, 1928, p. 48.

<sup>22</sup> *Ibid.*, p. 49.

<sup>23</sup> *Gaceta Oficial*, November 30, 1920, and December 31, 1920.

<sup>24</sup> See *Facts about Sugar* (Hoboken, N.J.), XI, 441, and XII, 22, 32.

<sup>25</sup> Emilio Roig de Leuchsenring, *Historia de la Enmienda Platt* (Havana, 1935), pp. 458-460.

sugar crop and stabilize the market.<sup>26</sup> None of these schemes, however, got beyond the stage of discussion.<sup>27</sup>

#### 4. THE TORRIENTE LAWS

Discarding all other proposals, the Cuban Congress enacted a group of three laws for the rehabilitation of the banking system, known as the Torriente Laws after their author, Senator Cosmé de la Torriente. The first of these provided for the gradual lifting of the moratorium, the second dealt with the reorganization or liquidation of insolvent banks, and the third created the Commission for Bank Legislation, which was to formulate proposals for a banking law. The Torriente Laws were in a measure responsible for the future development, or rather lack of development, of the Cuban banking system, and deserve to be reviewed in some detail.

##### A. LAW FOR THE LIFTING OF THE MORATORIUM

The first of the Torriente Laws, entitled "Law for the Lifting of the Moratorium" and enacted January 27, 1921, provided for the gradual repayment of debts, including bank deposits, in accordance with the following schedules:<sup>28</sup>

1. For debts other than bank deposits:

|                            |          |
|----------------------------|----------|
| 15 per cent payable within | 15 days  |
| 25 per cent payable within | 45 days  |
| 25 per cent payable within | 75 days  |
| 35 per cent payable within | 105 days |

2. For bank deposits:

|                            |         |
|----------------------------|---------|
| 15 per cent payable within | 15 days |
| 15 per cent payable within | 45 days |
| 20 per cent payable within | 75 days |

<sup>26</sup> Mario Guiral Moreno, *Cuba Contemporánea* (Havana), XXV (1921), 100 ff.

<sup>27</sup> Eventually the Cuban government floated a 5 million dollar loan (January 1922) which was followed by one for 50 million dollars later in the year. These loans, however, did not aim to rescue the banks or the sugar interests, but to bring Cuba up to date in her foreign debt service and to fund the floating debt.

<sup>28</sup> Secretaría de Hacienda, *Boletín Oficial*, March 1, 1921.

25 per cent payable within 105 days

25 per cent payable within 135 days

Adherence to these provisions was optional. Firms and banks that were able to resume full payments did so immediately, all of the foreign banks among them. Many merchants also made individual settlements with their creditors. But for firms and banks which continued to be short of cash, the staggering of payments authorized by the law offered a means of breaking the impasse which prevented the banks from paying their depositors because they could not call in their loans, while the debtors could not pay the banks because their deposits were immobilized.

Unfortunately the law also sanctioned the practice of compensations, by specifically permitting bank borrowers to pay off their loans with certified checks on the same bank. As long as certified checks could be purchased at a discount, therefore, many borrowers regarded it as a waste to pay their loans in cash, and the banks continued to receive very little cash, while losing the sound part of their assets. Thus, the law which was meant to facilitate the gradual unfreezing of deposits did much to frustrate its own purpose.

#### B. BANK LIQUIDATION LAW

The second of the Torriente Laws, dealing with bank liquidation,<sup>20</sup> applied to banks that had failed to meet the schedules

<sup>20</sup> Comisión Temporal, *Compendio*, 1924, p. 8.

set up in the first law. Upon suspending payments, these banks were to come under the administration of a Temporary Commission (Comisión Temporal de Liquidación Bancaria) created by the same law. The Temporary Commission, composed of three members and presided over by the Secretary of the Treasury, was to act as receiver and to appoint liquidating committees to conduct the affairs of each bank. Within three months after the suspension of payments, the liquidating committees were to present plans for reorganization, to be passed upon by the Temporary Commission. No plan could be approved unless all creditors could be paid within one year and unless at least



one-half of the bank's capital remained unimpaired. If these requisites could not be met, or if the creditors and stockholders of the bank failed to agree to the plan, the bank was to be placed in liquidation.

These provisions, modeled upon the receivership proceedings of American law, were in certain respects more severe than the bankruptcy regulations of the Cuban commercial code which would have governed in their absence. The commercial code allowed insolvent firms more time and scope to come to terms with their creditors, thus giving them a better chance to regain their solvency. There is some reason to think that without this law the native banking system would have stood a better chance of survival. García alleged that the law was purposely designed to make the liquidation of suspended banks inevitable. He also suggests that it was formulated by American lawyers, implying that American interests wanted to destroy the Cuban banking system in order to increase Cuba's dependence upon the United States.

A less sinister interpretation suggests that the framers of the laws underestimated the difficulties which stood in the way of refloating the banks. Public opinion appears to have been optimistic about the future of at least some of the banks, such as the Nacional, although the ultimate collapse of the Español seems to have been generally expected.<sup>30</sup> This optimism was shared not only by representatives of the American government, but apparently also by the former Havana manager of the National City Bank, Porfirio Franca, who early in 1921 accepted the presidency of the Banco Nacional. If Senator Torriente had known how unfounded this optimism was, he might have formulated a more lenient reorganization law.

But if the Bank Liquidation Law made reorganization unduly difficult, it permitted a more lenient treatment of the banks after they had definitely been closed than did the commercial code. Under the code it would have been necessary to auction off their assets in short order, once attempts at a settlement had failed. The chances were that very little would have been realized if large amounts of real estate and numerous sugar proper-

<sup>30</sup> *Cuba Bulletin* (Havana), February 1921, p. 11.

ties had suddenly been thrown on the market. Owing to the impoverishment or illiquidity of most Cuban capitalists, moreover, the buyers of these assets would have been chiefly Americans. The application of the commercial code, therefore, would not only have injured the creditors of the closed banks, but would also have done permanent harm to Cuba through the alienation of much of her wealth.

That calamity the Bank Liquidation Law was designed to avoid. One cannot say that it achieved an outstanding success, since much Cuban property nevertheless passed into American hands, but on the whole the law probably safeguarded to some extent the interests of the country. Whether the same can be said of the interests of the banks' creditors is much less certain. While the longer liquidation period permitted better prices to be obtained for their assets, it also caused heavy liquidation expenses. With the passage of time, many of the bad assets became worse instead of better, and good assets were frequently squandered by allowing their redemption in certified checks. From the creditors' viewpoint, the outcome of the receivership was not gratifying.

#### C. COMMISSION FOR BANK LEGISLATION

The third of the Torriente Laws created the Commission for Bank Legislation (*Comisión de Legislación Bancaria*), of which Senator Torriente later became the chairman. The Commission eventually evolved a project embodying a central bank, a banking law, and the framework for agricultural banks.<sup>31</sup> If enacted, the project would have contributed materially toward rebuilding the Cuban banking system. Unfortunately, it remained securely buried in the Cuban Congress, and Cuba therefore remained not only without a central bank, but also without a domestic banking system.

#### 5. LIQUIDATION

The final collapse of most of the domestic Cuban banks came quickly. One by one, the banks failed to meet their scheduled quotas and suspended payments. Altogether, twenty banks

<sup>31</sup> Secretaría de Hacienda, *Boletín Oficial*, December 1, 1922.

with 334 branches closed their doors.<sup>32</sup> As soon as a bank had declared itself insolvent, the Temporary Commission would take over and appoint a liquidating committee. Then the slow and tedious process of establishing the order of precedence of the various creditors would begin, in accordance with the provisions of the Commercial Code.<sup>33</sup> Assets would be liquidated gradually, largely through public auction. Payment was required sometimes in cash, sometimes in certified checks, and sometimes in varying proportions of both.<sup>34</sup> In some cases, the cash receipts barely covered the expenses of the receivership. In most others, they were exhausted after payment of the preferred creditors. These instances included the Banco Nacional, which paid 30 per cent of its liabilities, and the Español, which paid 10 per cent. The liquidating dividend of the Nacional was made possible only because the government, which had become a preferred creditor, was willing to accept a compromise for the benefit of junior claims.

These disappointing results cannot, however, be regarded as a measure of the losses suffered by bank depositors. By the time the final outcome of the receiverships had been determined, the volume of claims had been reduced to a small fraction of the original amount through compensations and legitimate and illegitimate withdrawals. It was therefore not too important whether the bitter-enders, who did not avail themselves of such devices, received much, little, or nothing. The most significant measure of losses suffered is given by the discounts at which the majority of depositors liquidated their claims through certified checks. The rates presented in the accompanying tabulation give an approximate idea of the progressively larger losses sustained.<sup>35</sup>

<sup>32</sup> Comisión Temporal, *Compendio*, 1924, p. 24, and *Compendio*, 1928, p. 119.

<sup>33</sup> *Código de Comercio*, Sección 5, título 1, book 4, and *Código Civil*, capítulo 3, título 17, book 4, as mentioned in Comisión Temporal, *Compendio*, 1928, p. 123.

<sup>34</sup> Commerce, *Economic Conditions in Cuba*, p. 8.

<sup>35</sup> *Cuba Bulletin* (Havana), January 1921, p. 11; Commerce, *Economic Conditions in Cuba*.

## VALUE OF CERTIFIED CHECKS, IN PER CENT OF PAR

|                                 | <i>Banco<br/>Nacional</i> | <i>Banco<br/>Internacional</i> |
|---------------------------------|---------------------------|--------------------------------|
| October–December 1920 . . . . . | 70–80                     | 48                             |
| Early 1923 . . . . .            | 44                        |                                |
| August 1923 . . . . .           | 50–55                     | ½–1½                           |
| September 1923 . . . . .        | 40                        | 1                              |

On the whole, nevertheless, the losses caused by the bank crash probably were smaller than the number and importance of the succumbing institutions would seem to indicate. This impression is supported by the quick recovery that took place in 1923 when the price of sugar temporarily rose to 6 cents.

Of the twenty banks that suspended, sixteen were immediately liquidated by the Temporary Commission, while two more were closed later, after an unsuccessful reorganization.<sup>36</sup> Reorganization proposals submitted by the Banco Nacional and the Banco Español failed to meet the standards laid down by the second Torriente Law and had to be rejected. The Commission vainly appealed to President Zayas for a relaxation of these standards.<sup>37</sup>

The liquidations came to an end in 1927 with the dissolution of the Temporary Commission, but the ultimate fate of most of the Cuban banks had been decided long before that time. Of the larger domestic banks, the only ones to survive the crisis were Gelats and Company, the Banco Territorial de Cuba, and Pedro Gómez Mena. The latter firm was taken over by the Royal Bank of Canada two years later. The foreign banks, with the large resources of their head offices behind them, were able to weather the storm. Their losses, however, were very heavy, and the Banco Mercantil was liquidated by its sponsors after meeting all claims.<sup>38</sup> In the process of taking over the assets of their defaulting debtors, the foreign banks acquired very

<sup>36</sup> Comisión Temporal, *Compendio*, 1924, p. 24, and *Compendio*, 1928, p. 119.

<sup>37</sup> *Ibid.*, 1924, p. 100; 1928, p. 59.

<sup>38</sup> Two North American banks are reported to have lost 25 million dollars each, while the institution which liquidated reportedly lost 20 million (Jenks, *Our Cuban Colony*, p. 232, n. 4).

substantial property interests, primarily in the sugar industry, some of which they were unable to dispose of until after the outbreak of the Second World War, when a new sugar boom got under way. Frozen loans remained on their books for many years.

The disappearance of most of the domestic Cuban banks left the foreign banks in a dominant position. The ranks of the latter were further swelled by the establishment of a branch of the First National Bank of Boston in 1923. The Chase National Bank entered the scene in 1925, by taking over the Cuban

TABLE 3  
LOANS AND DEPOSITS OF CUBAN BANKS, 1916-1931  
(In millions of dollars/pesos)

| End of Year       | Loans                      |                             |       | Deposits                   |                             |       |
|-------------------|----------------------------|-----------------------------|-------|----------------------------|-----------------------------|-------|
|                   | Foreign banks <sup>a</sup> | Domestic banks <sup>b</sup> | Total | Foreign banks <sup>a</sup> | Domestic banks <sup>b</sup> | Total |
| 1916              | 27.2                       | 70.5                        | 97.7  | 30.7                       | 109.0                       | 139.6 |
| 1917              | 36.5                       | 101.7                       | 138.2 | 40.6                       | 147.0                       | 187.6 |
| 1918              | 44.4                       | 124.9                       | 169.3 | 51.6                       | 170.7                       | 222.3 |
| 1919              | 86.1                       | 155.6                       | 241.7 | 81.5                       | 234.7                       | 316.2 |
| 1920 <sup>c</sup> | 82.8                       | 203.1                       | 285.9 | 88.2                       | 352.5                       | 440.7 |
| 1921              | 85.8                       | 10.1                        | 104.9 | 55.2                       | 24.8                        | 80.0  |
| 1922              | 80.9                       | 16.9                        | 106.8 | 72.5                       | 32.2                        | 104.8 |
| 1923              | 101.8                      | 17.9                        | 119.8 | 104.3                      | 32.4                        | 136.7 |
| 1924              | 114.8                      | 17.4                        | 132.2 | 123.9                      | 33.7                        | 157.6 |
| 1925              | 152.2                      | 17.3                        | 169.5 | 134.8                      | 38.8                        | 173.6 |
| 1926 <sup>d</sup> | 201.3                      | 26.5                        | 227.8 | 106.2                      | 61.3                        | 167.6 |
| 1927              | 181.9                      | 27.5                        | 209.4 | 177.7                      | 61.7                        | 239.4 |
| 1928              | 164.8                      | 26.8                        | 191.6 | 181.3                      | 61.1                        | 242.4 |
| 1929              | 157.4                      | 26.6                        | 183.9 | 166.0                      | 56.4                        | 222.4 |
| 1930              | 139.9                      | 23.7                        | 163.6 | 107.7                      | 37.0                        | 144.7 |
| 1931              | 116.4                      | 18.7                        | 135.1 | 85.9                       | 25.1                        | 111.0 |

<sup>a</sup> For 1916-1920, the data include the Royal Bank of Canada, the National City Bank, and the Bank of Nova Scotia. For 1921 and later, the Canadian Bank of Commerce is included, and for 1923 and later, the First National Bank of Boston.

<sup>b</sup> For 1916-1920, the data include the Banco Nacional, the Banco Español, the Banco Internacional, the Banco Territorial de Cuba, and N. Gelats y Cia. For 1921-1925, only the Banco Territorial and N. Gelats are represented.

<sup>c</sup> June 30

<sup>d</sup> Beginning 1926, the data are based on the semiannual reports made to the Treasury by all Cuban banks and are therefore virtually complete.

business of the American Foreign Banking Corporation. Three new Cuban banks were also established about that time, the Banco Nuñez, the Banco Comercial, and the Banco de Comercio. They were small institutions, however, and did not materially diminish the preponderance of the foreign banks.

The extent to which the distribution of resources between domestic and foreign banks was reversed as a result of the crisis is illustrated in Table 3. Whereas by 1923 the foreign banks had more than recouped the losses in deposits caused by the crash, the surviving domestic banks had retained less than 10 per cent of the deposits which the domestic sector had held in 1920. Of total deposits the foreign banks controlled 76.1 per cent in 1923, while in 1920 they had only 20.0 per cent.

## 6. THE FEDERAL RESERVE AGENCIES

The events of the year 1920 had made it abundantly clear that Cuban banking was in need of a stabilizing element. Senator Torriente looked to his central bank project to meet this need; the banks and many other interests who feared a Cuban central bank hoped, on the other hand, for an extension of the Federal Reserve System to cover Cuba. As early as 1921 the prestige of the system had been employed to fortify the banks against the effects of rumors that were circulated regarding their solvency. At that time (September 29, 1921), the National City Bank had been nominated as agent of the Federal Reserve Bank of New York in Cuba, and publicity had been given to the appointment. The arrangement appears to have had mainly formal significance, and no transactions seem to have been carried out under it. In 1923, however, closer ties were established between Cuba and the Federal Reserve System. Instead of Senator Torriente's central bank there now appeared on the scene the agencies of the Federal Reserve Banks of Boston and Atlanta.

The Boston bank seems to have taken the initiative in establishing an agency. The Atlanta bank, however, had a special interest in Cuba, because a large part of the dollar bills circulating on the island had been issued by it and had contributed to the expansion of its assets. The dominance of Atlanta notes

in the Cuban circulation was due to the geographical advantages enjoyed by the bank, whose Jacksonville branch was in a position to ship currency to Cuba more cheaply than was possible from New York or Boston. In order to harmonize the interests of Boston and Atlanta, the Federal Reserve Board segregated the functions of their agencies. The Atlanta agency was to issue all notes, both for the purpose of providing fit currency and for the payment of wire transfers, while the Boston agency was to conduct the actual banking operations. These included the purchase and sale of wire transfers for the Cuban government and the banks, as well as dealings in two-name acceptances with up to ninety days' maturity and in foreign exchange.<sup>39</sup>

The agencies performed central bank functions only to a very limited extent. They did not engage in the regulation of credit, and were, in fact, considered as having no credit functions at all, although their power to purchase ninety-day bills might be so regarded. They could do nothing to make credit available to those sectors of the Cuban economy that were unable to gain the confidence of the foreign banks. Extension of credit to the government was similarly beyond their power. In all these respects, their functions fell short of the powers which a Cuban central bank probably would have had. Moreover, their mere presence was sufficient to put a damper on all plans for the establishment of such a bank.

The central bank functions of the agencies in effect consisted of nothing more than the supply of emergency reserves which the banks could draw upon in a crisis by means of wire transfers from their head offices. This service, however, was of not inconsiderable importance. After the events of 1920 the banks realized that in case of a run they could not rely on currency shipments from the mainland. The interval of two or three days between the request for a shipment and its arrival might spell disaster, and it seemed necessary, therefore, to carry large and costly reserves in Cuba. This necessity was in part obviated by the presence of the agencies, which were expected to carry adequate stocks of currency. The saving to the banks was considerable, and although it is said not to have led to an im-

<sup>39</sup> The agencies were set up under Section 14 (c) of the Federal Reserve Act.

mediate lowering of interest rates, it probably paved the way toward a gradual reduction in the Cuban rate structure. In later years the bankers repeatedly stated that a withdrawal of the agencies would force them to carry larger reserves and to charge higher interest rates.

A considerable saving to Cuban business also resulted from the Boston agency's willingness to make wire transfers at the very reasonable charge of one-tenth of one per cent. Prior to the establishment of the agencies, the banks had actively traded with each other in New York funds and had charged their customers for transfers in accordance with the prevailing rate. This rate fluctuated between limits very similar to the gold points which regulate exchange movements under the gold standard — "currency points" seems an appropriate name for them. The currency points were given by the discounts or premia required to cover the cost of shipping currency to or from Cuba, and varied according to the denominations of the bills, large denominations causing comparatively less expense because of their reduced bulk. The margin, however, was almost always larger than one-tenth of one per cent. After the Boston agency's wire transfer service went into operation, the range of the currency points was narrowed to one-tenth of one per cent above and below par, as charged by the agency. Inter-bank dealings in New York funds became infrequent thereafter, and most transfers were made through the Boston agency. The fluctuations in the rate at which the banks sold New York funds to their customers became very small, and Cuban business firms usually could buy or sell New York funds at a cost of one-tenth of one per cent. While the system did not quite achieve the ideal of perfect exchange parity with the entire dollar area, which the Federal Reserve System had virtually realized within the United States, it came very close to it.

The first heavy test to which the agencies were subjected occurred early in April 1926. A run developed on the Royal Bank of Canada and soon spread to other banks. Large-scale withdrawals took place on Saturday, April 10, and further heavy drains occurred on the succeeding Monday. To meet these demands, the Havana banks turned to the Federal Re-



serve agencies. From the New York district alone, 31.2 million dollars were transferred to Cuba via Boston. Thanks to the aid of the Federal Reserve System all withdrawals could be met, and the run subsided. The System therefore appeared to have met its first severe test with success.

Nevertheless, it had been a close shave. The stock of currency carried by the Atlanta agency had been insufficient to cover the inward wire transfers of the Boston agency, and on the critical Saturday it became necessary to rush shipments from the Atlanta bank's Jacksonville branch. But for the intervening Sunday, the shipments would have come too late.<sup>40</sup> This would have placed the Federal Reserve agencies in the very embarrassing position of being temporarily unable to meet their obligations and might have had very grave consequences for the Cuban banks. The renewed demonstration of the instability of the Cuban banking situation probably was one of the reasons which induced the Boston Reserve Bank to withdraw its agency a few months later. Thereafter, the agency of the Atlanta bank did both the currency and the wire-transfer business.

It was the policy of the agency to maintain a more or less constant reserve of currency in its vault, and to balance an excess of receipts or payments through prompt shipments to or from the United States. The agency's holdings were never very large and hence not sufficient to meet a major crisis, as the 1926 episode had made apparent. With the development of better airmail service to Havana, however, the danger that the agency might be caught with insufficient funds soon diminished. In 1938, shortly before it ceased to operate, the agency carried no more than 5.5 million in notes.

<sup>40</sup> See Bureau of Foreign and Domestic Commerce, *Latin American Monetary and Exchange Conditions*, Trade Information Bulletin No. 430 (Washington, 1926), p. 14.

## **PART III**

### **THE DOUBLE STANDARD, 1932–1945**



## CHAPTER IV

### THE NEW MONETARY SYSTEM

THE YEAR 1932 ushered in the first of a long series of issues of silver pesos, initiating a development that was to lead to a radical change in the Cuban monetary system. The silver circulation, first in the form of coins of one peso and later as silver certificates, tended to play an increasingly important part in the transactions of the internal economy and at times completely displaced the dollar in that sphere. As a result, Cuba's monetary system during the later thirties lost much of the elasticity and stability which it had originally possessed, and foreign exchange problems, previously conspicuously absent, began to arise.

During the period from 1932 to 1939 a total of 79.6 million silver pesos was issued by the Cuban Treasury, bringing the aggregate volume of Cuban silver to 89.3 million.<sup>1</sup> From 1935 onward, silver certificates fully backed by coined silver in the Treasury took the place of the inconveniently heavy coins. Special issues of certificates were made in 1936 and 1938 to withdraw an equivalent amount of silver coins from circulation. Largely as a result of the peso expansion, the dollar currency in the hands of the public suffered a gradual shrinkage, which by the end of 1938 had reduced it to 12.6 million, most of which was hoarded.

A similar development took place in the composition of bank deposits. Before 1932 the banks had not distinguished between deposits made in dollars and those made in Cuban silver pesos. Owing to the discount of the peso that developed thereafter, however, the banks began to carry separate accounts for the two currencies and made some of their loans in silver pesos. The expansion of peso deposits, however, and the correspond-

<sup>1</sup> This total includes a small issue against gold backing of 1,240,712 pesos.

ing shrinkage in dollar deposits were somewhat less pronounced than in the case of peso and dollar currency.

During the years 1939 to 1941, the peso remained at a sizable discount from the dollar, and the latter practically ceased to circulate in the internal market. Owing to the war, however, the dollar staged a rapid comeback, and by the end of 1945 dollar currency and dollar deposits again represented an important, though not predominant, part of the money supply. These developments will form the main topic of the following chapters.

TABLE 4  
MONEY SUPPLY, 1932-1941<sup>a</sup>  
(In millions)

| End of<br>Year | Gold Coins |                  | Silver Coins and<br>Subsidiary<br>Currency |       | Silver<br>certificates | Dollar<br>bills | Demand Deposits |       | Total <sup>b</sup> |
|----------------|------------|------------------|--------------------------------------------|-------|------------------------|-----------------|-----------------|-------|--------------------|
|                | U S        | Cuban            | U S                                        | Cuban |                        |                 | Dollars         | Pesos |                    |
| 1932           | .8         | 5.5              | .4                                         | 9.5   |                        | 25.4            | 68.6            |       | 110.1              |
| 1933           | 1.0        | 4.3              | .5                                         | 14.3  |                        | 31.3            | 56.3            |       | 107.8              |
| 1934           |            | ( <sup>c</sup> ) | .6                                         | 20.5  |                        | 25.4            | 54.7            |       | 101.1              |
| 1935           |            |                  | .2                                         | 11.5  | 15.4                   | 19.9            | 59.9            |       | 106.9              |
| 1936           |            |                  | .2                                         | 8.5   | 26.1                   | 15.5            | 71.5            |       | 121.6              |
| 1937           |            |                  | .2                                         | 14.5  | 33.6                   | 14.1            | 42.6            | 38.5  | 143.4              |
| 1938           |            |                  | —                                          | 8.6   | 38.5                   | 12.6            | 36.4            | 43.2  | 139.2              |
| 1939           |            |                  | .1                                         | 7.4   | 45.8                   | 14.1            | 26.6            | 52.8  | 146.8              |
| 1940           |            |                  |                                            | 7.0   | 53.8                   | 19.4            | 31.8            | 51.1  | 163.2              |
| 1941           |            |                  | .1                                         | 6.9   | 60.8                   | 29.4            | 47.6            | 47.6  | 192.4              |

<sup>a</sup> Currency, coin, and demand deposits in the hands of the public and Treasury

<sup>b</sup> Discrepancies are due to rounding.

<sup>c</sup> Gold demonetized

Sources Dirección General de Estadística, *Circulación Monetaria y Movimiento Bancario* (Havana, 1936, 1941); various publications of the Cuban Treasury.

## I. THE SILVER ISSUES OF 1932-33

The first of the new silver issues made its appearance during a period of grave crisis. Since 1927 Cuba had enjoyed very little prosperity, and by the beginning of 1932 conditions had reached a stage of unprecedented depression. The previous (1931) sugar crop had been sold at an average price of 1.152

cents per pound f.o.b. Cuban ports, compared with 2.942 cents in 1927. Exports had shrunk from 324.4 million pesos in 1927 to 118.9 million in 1931. Budgetary appropriations, which as late as 1929-30 amounted to 85.4 million, had been pared to 60.4 million for the fiscal year 1931-32, and a further cut to 51.5 million was in prospect for the following period. Revenues were insufficient to cover even these reduced expenditures, and the floating debt was mounting.

The budgetary problem was particularly grave, because Cuba's capacity to finance a deficit through regular short-term borrowing was very limited. Most of the floating debt, insofar as it did not originate through the public works financing arranged by the Chase National Bank, consisted of unpaid bills and salaries. These continued to accumulate, while the government made frantic efforts to meet installments on the foreign debt. Although the Emergency Law of 1931 had cut salaries and imposed higher taxes, difficulties in 1932 became so great that enough cash could not be raised to meet foreign obligations of 8.3 million falling due on June 30. Fiscal disaster threatened.

#### A. THE ISSUE OF 1932

It was this situation which produced the "happy thought" of financing part of the debt service with the seigniorage profit of an issue of silver money. It will be recalled that of the 12 million silver pesos authorized by the monetary legislation of 1914 only 8.4 had been issued, so as to avoid glutting the circulation with subsidiary money. Here, then, was an opportunity to raise money which, if not quite orthodox, was at least perfectly legitimate. The price of silver was low (below 30 cents per ounce), and the profit on a permissible issue of 3.6 million promised to be over 2.5 million. This amount, together with certain tax receipts and a loan from the Chase National Bank of 2.3 million dollars, was sufficient to take care of obligations maturing on June 30, 1932.<sup>2</sup>

The decree which authorized the new issue stated that the coinage was motivated by the need for circulating medium.<sup>3</sup>

<sup>2</sup> Secretaría de Hacienda, *Boletín Oficial*, 1932, p. 726.

<sup>3</sup> Decree 324, February 29, 1932, *Gaceta Oficial*, March 19, 1932.

Given an inflationistic interpretation, this motivation could not have been regarded as inconsistent. Deflation had gone far in Cuba, and many Cubans would have welcomed money creation on a large scale.<sup>4</sup> But this policy was not consonant with the Machado government's general policy up to that time, which had adhered fairly closely to the tenets of "sound finance." The Machado government, generally willing to lend an ear to the wishes of American financial interests and determined to meet its foreign obligations at all costs, had little interest in promoting inflation. It may therefore be taken for granted that the real motive for the coinage was not an increase in the money supply, but the seigniorage profit.

In fact, far from there being a shortage of the type of money that was about to be minted (one-peso coins and smaller), the circulation actually was saturated with it. It will be remembered that the legal tender power of silver was limited to amounts of ten pesos or 8 per cent of each payment, whichever was larger. Subsidiary coin was legal tender only up to one peso. It is clear that as the volume of silver increased relative to the aggregate circulation, a rigorous insistence upon legal tender provisions on the part of payees was bound to create difficulties.<sup>5</sup> Some businesses, such as the street-car system, took in most of their receipts in the form of silver. Banks having large amounts of silver on hand from other sources became reluctant to accept further deposits from such customers and were, of course, within their rights in rejecting them. Bottlenecks of this kind probably were responsible for the relatively small amount of subsidiary coin that the circulation was able to absorb and for the repeatedly manifested tendency of silver to go to a discount. Of these facts the government could hardly plead ignorance, since previously it had persistently endeavored to keep down the circulation of subsidiary currency in order to maintain it at par.

Among the arrangements made to this end was an agreement

<sup>4</sup> See Foreign Policy Association, *Problems of the New Cuba*, p. 315.

<sup>5</sup> Something of this kind had, in fact, happened as early as 1927, whereupon the Treasury had exported American subsidiary coin to the States to reduce the circulation.

under which the Treasury relieved the banks of their excess holdings of silver currency. Just prior to the announcement of the forthcoming coinage, however, a shortage of funds had forced the Treasury to give up this practice and to pay out its accumulated silver to reimburse the banks for Treasury checks honored by them.<sup>6</sup> The result had been the appearance of a slight silver discount in January 1932. When the decision to increase the silver circulation was taken, that discount was already plainly in evidence, indicating that even the existing circulation was obviously and palpably excessive.

It is interesting to note that early in 1932 a discount existed not only on silver, but strangely enough also on Cuban gold coins. This phenomenon is explained by the fact that the coins, although included in bank reserves, were not a satisfactory medium for that purpose. Since they had virtually ceased to circulate, the banks generally refrained from paying them out. When a temporary shortage of other reserves forced the banks to deviate from this practice, the stringency was thereby revealed to the public, which naturally was embarrassing to the banks. The gold discount, however, did not go high enough to make specie exports profitable, for which, moreover, a license would have been required.<sup>7</sup>

The contract for the coinage of 3.6 million pesos was awarded to the Chase National Bank on April 7, 1932. The coins did not make their appearance until a few months thereafter,<sup>8</sup> and thus did not become an immediate burden upon the market. The announcement of the impending issue, however, created a general feeling of uncertainty about the future of the currency. The public realized that the project was a device to make up part of the deficit. Since deficits were a standing feature of Cuban budgets, a repetition of this method of financing seemed not altogether unlikely, and such prospects undoubtedly had an unfavorable influence upon the value of the silver peso.

<sup>6</sup> Secretaría de Hacienda, *Boletín Oficial*, edición extraordinaria, October 1931, p. 9.

<sup>7</sup> *New York Times*, August 28, 1932, mentions a gold discount of one-fourth of one per cent.

<sup>8</sup> *Ibid.*, April 8, 1932.



Nevertheless, there was no panic, nor even a noticeable increase in the steady net drain of dollars which had been going on for years. In the statistics of currency movements, the effect of the 1932 silver issue is reflected only in the almost complete absence of dollar imports during that year.<sup>9</sup> The immediate effect of the announcement was merely a rise in the discount on silver from a small fraction in January and February to a rate of  $\frac{3}{4}$ -1½ per cent in March. For a while the demand for circulating medium during the sugar crop season helped to prevent a more noticeable decline. But as the harvest drew to an end and the new silver coins began to enter into circulation, the discount widened. The government began to pay its employees exclusively in silver, in order to accumulate dollars for its debt service.<sup>10</sup> After every pay day the peso took a drop, recovering only partially before the next occasion.<sup>11</sup> Early in August the discount had mounted to  $2\frac{3}{4}$ -4 per cent (see Table 7). At the beginning of September it touched 5 per cent. Press reports, allegedly reflecting the opinion of financial circles, predicted that the discount might go as high as 10 per cent.<sup>12</sup> Small exchange shops flourished.

#### B. THE REACTION OF THE BANKS

As a result of the peso discount, the banks, for the first time since 1914, were faced with a foreign exchange problem. In accepting pesos, even at a discount, they were taking a distinct risk, since in the case of further depreciation they could have disposed of their holdings only at a higher discount. The banks met this situation by setting up separate silver accounts for their customers, to which silver deposits were credited and against which drawings could only be made for silver. Thus

<sup>9</sup> Although a net outflow of dollars had taken place in every half year after the first half of 1929, there had always been some currency imports to offset part of the withdrawals. Part of these imports, however, probably reflected the substitution of fit currency for unfit bills withdrawn by the Atlanta agency, rather than commercial shipments.

<sup>10</sup> *Ibid.*, August 28, 1932.

<sup>11</sup> José Manuel Bermúdez y Quadreny, *Porqué Baja el Peso de Plata* (Havana, 1938), p. 7.

<sup>12</sup> *Heraldo de Cuba*, August 24, 1932, quoted in *New York Times*, August 28, 1932.

they were able to balance their position if they wished to, and to avoid the exchange risk. For a while some of the banks refused to accept silver in payment of drafts on foreign centers, since this likewise would have meant to take an exchange position. Silver became freely acceptable only as a market for it began to develop among the banks in which they could equalize their position.

The banks came in for a good deal of public criticism in connection with the depreciation of the peso, and were accused both of producing the discount and of profiting from it. The primitive notion that the banks, in selling pesos against dollars and vice versa, pocketed the entire amount of the discount, was of course wholly erroneous.<sup>13</sup> The banks' profit on exchange dealings could not be greater than the spread between the buying rates, which generally was less than one per cent and often as little as one-eighth. A charge which cannot so easily be disposed of is the assertion that the banks contributed to the decline of the peso through their exchange policy. There can be no question that the banks were justified in refusing to take in unlimited amounts of silver; the problem of maintaining the silver peso at par was a responsibility of the government, not of private business. The banks were likewise within their rights in setting up separate silver accounts, insofar as by this action they aimed to protect themselves against exchange fluctuations. It is possible, however, that some banks may have attempted to profit from the drop in the peso by taking a short position. To the extent that they did so — there are no data to confirm or disprove the case — they contributed to the weakness of the currency.

#### C. GOVERNMENT COUNTERMEASURES

The government at first did little to meet the problems created by the silver discount. In former years its policy had been to accept silver without limitation in payment of taxes and dues, with the exception of customs duties and special taxes pledged for the public debt.<sup>14</sup> But when the discount appeared, govern-

<sup>13</sup> Quoted disapprovingly by *Cuba Económica y Financiera*, August 2, 1936, p. 17.

<sup>14</sup> Secretaría de Hacienda, *Boletín Oficial*, 1932, edición extraordinaria, p. 105.

ment offices began to insist upon the legal tender limitations of Cuban silver and rejected coins in excess of 8 per cent of tax payments. The customs and various other departments refused to accept silver at all.<sup>15</sup> Such measures may have been necessary to enable the Treasury to accumulate sufficient dollars for the service of the foreign debt, but their result was, of course, to put further pressure upon the peso.

As the discount increased, however, the government decided to take countermeasures. In May 1932 the amount of silver acceptable in payment of taxes was raised to 20 per cent. The relief afforded was small, however, and the peso continued to depreciate. The government's efforts to effect a rapid reduction in the volume of one- and two-dollar bills in circulation also failed to check the decline of silver.

Although the fundamental causes of the discount were plain enough, the government did what governments all over the world have done in similar situations: it put the blame upon speculators and currency manipulators, and threatened money changers with fines and arrest.<sup>16</sup> Public officials allegedly attempting to exploit the situation for their own benefit were threatened with dismissal and civil prosecution.<sup>17</sup> The banks, however, apparently were permitted to conduct exchange operations of dollars against pesos without molestation.

The fear that the discount might eventually reach 10 per cent or more turned out to be unfounded. The main reason probably was that the depreciating peso tended to drive the dollar out of circulation, without being able fully to displace it, as long as the volume of pesos was insufficient to cover the full needs of trade. (This aspect will be discussed below in greater detail.) Two further measures taken by the government also helped the peso. One, which took place toward the end of 1932, was a further increase to 35 per cent in the amount of silver accepted

<sup>15</sup> *New York Times*, April 26, 1932.

<sup>16</sup> *Ibid.*, August 28, 1932.

<sup>17</sup> Some officials seem to have employed government funds under their control to conduct exchange operations, thereby depriving the Treasury of the dollars it was attempting to accumulate. See Decree of August 23, 1932, Secretaría de Hacienda, *Boletín Oficial*, 1932, p. 1005.

for taxes.<sup>18</sup> The other was an order placing army trucks at the disposal of the banks for the purpose of shipping silver currency to their branches. This reduced the banks' handling expenses, served to insure a better distribution of silver through the island, and alleviated the congestion of coin in Havana, where silver tended to accumulate. Under the joint influence of all these factors, the discount, after touching a maximum of 5 per cent in September, began to diminish rapidly, until in November 1932 it had been reduced to  $1\frac{1}{2}$  per cent.

#### D. THE ISSUE OF 1933

The profit realized upon the issue allowed the government to meet the June 1932 installment of the Public Works debt, but greater difficulties lay ahead. The December maturities could be met only with the aid of a 3-million-dollar bank credit and a 1.8-million-dollar advance from three oil companies.<sup>19</sup> In order to raise the balance out of revenues, the government had to allow its remaining obligations, chiefly salaries and pensions, plus suppliers' bills, to fall further into arrears. The situation of government employees became so difficult that payment of salaries in scrip was being considered.<sup>20</sup>

In April 1933 the government was authorized by the legislature to suspend at its discretion the amortization of Cuba's foreign and domestic debt. Rather than do this, however, the government decided to put out another issue of silver pesos. The new coinage, announced on April 3, 1933, was fixed at six million pesos. The limitation on silver established by the legislation of 1914 was therewith suspended. While no one doubted that the motives again were budgetary ones, the decree spoke of the country's need for more circulating medium, striking for the first time a distinctly inflationary note. Taking its cue from contemporary efforts in other countries to raise the price level by monetary means, it suggested that Cuban agriculture might

<sup>18</sup> Pérez and Pazos, *El Problema Monetario*, p. 46.

<sup>19</sup> This advance was a prepayment of duties on oil to be imported subsequently.

<sup>20</sup> Bureau of Foreign and Domestic Commerce, *Latin American Financial Notes* (Washington), No. 117, 1933, p. 18.

benefit from an additional silver issue. At the same time, however, the preamble of the decree endeavored to demonstrate that a renewed depreciation of the peso was not to be feared. In support of this contention, it was argued that the discount of 5 per cent which followed upon the first issue was due primarily to the bad press which that measure had had, that business had improved meanwhile, and that the scarcity of currency experienced during the 1933 crop season made an increase in the money supply desirable.

As it turned out, the government was nearly right in asserting that the reappearance of a major discount was not to be anticipated. Although the coins again were placed in circulation at a most unpropitious moment, the discount leveled off at  $2\frac{1}{2}$  per cent during June, and after hovering between 2 and 3 per cent in July, receded to  $1\frac{1}{2}$  per cent in August and  $1\frac{1}{4}$  in September. This recovery was all the more remarkable since it occurred at a time of political unrest. The Machado government fell on August 11, 1933, and after a brief interregnum of a provisional president, succeeded by a revolutionary junta, the Grau San Martín government took office. While the fall of Machado probably was greeted with relief by even some of those interests toward whom he had always been friendly, the strongly Leftist trend of the Grau administration could not fail to arouse apprehension. No reflection of this feeling, however, is found in the trend of the peso discount prior to December 1933, or in the export of currency, both of which remained moderate.

The Grau government made two contributions to exchange stability. One was the suspension of payments on the Public Works debt, an action which had primarily budgetary significance, but served also to reduce the government's need for dollars. The other was to increase to 70 per cent the proportion of silver accepted in payment of taxes.<sup>21</sup> In December, however, the announcement that a new silver issue of 20 million pesos was about to be made caused the peso to break temporarily to  $3\frac{1}{2}$  per cent below parity. The new government used no subterfuges, stating simply and honestly that the issue

<sup>21</sup> Pérez and Pazos, *El Problema Monetario*, p. 32.

was necessary because the economic situation did not permit the creation of new taxes. Once more, however, the exchange recovered rapidly, and by April 1934, at the height of the crop season, the discount was only  $\frac{1}{4}$  per cent. This improvement made possible a reduction in the proportion of silver acceptable in payment of taxes to 60 per cent. Some taxes, however, already were payable 100 per cent in silver at that time.<sup>22</sup>

The sensitiveness of the peso to announcements of new issues, which was quite as pronounced as its reaction to the actual appearance of new coins is not uninteresting. It seems to indicate that the factors tending to produce a discount were in large part psychological. The rapid recovery on each occasion may be ascribed to the improved economic situation, as well as to the displacement of dollars. It is surprising, however, that the period of social experimentation following the fall of Machado failed to have a more significant effect on the peso.

## 2. THE MONETARY REFORM OF 1934

During the spring and summer of 1934 the Mendieta government, which meanwhile had succeeded the Grau administration, passed a series of measures which both in design and in effect were more far-reaching than any yet undertaken. The action began, conservatively enough, with a reduction to 10 million pesos of the 20 million issue planned by the Grau government. This was announced on March 22, 1934.<sup>23</sup> On April 19, however, all restrictions on the acceptability of silver for tax payments were lifted, and the metal became unlimited legal tender for payments to the Cuban government, the provinces, and the municipalities.<sup>24</sup>

Barely a month later a second and final step was taken toward a complete equality between the silver peso and the dollar. By Decree 244 of May 22, the silver peso became unlimited legal tender for transactions of all kinds, public and private.<sup>25</sup>

<sup>22</sup> *Ibid.*, p. 32.

<sup>23</sup> Decree laws 92 and 93 of March 22, 1934, *Gaceta Oficial*, March 22, 23, 1934.

<sup>24</sup> Decree law 153 of April 19, 1934, *Gaceta Oficial*, April 24, 1934.

<sup>25</sup> *Gaceta Oficial*, May 23, 1934, and repeated, with corrections, in decree law 256 of May 25, 1934. *Gaceta Oficial*, May 26, 1934.

Even contracts made before this date, which almost invariably were in dollars or in "moneda nacional" (Cuban gold pesos or dollars), would thereby have become payable in silver pesos at par. This particular feature was revoked a week later,<sup>26</sup> owing to the strenuous protests of injured creditors, but contracts made after May 22 were henceforth to be dischargeable in silver pesos as well as in dollars at par, irrespective of the currency stipulated.<sup>27</sup> Finally, a few days later, foreign exchange control was introduced.<sup>28</sup>

It is unwise to read into the actions of the rapidly shifting governments of that period an expression of long-run policies. Whatever was done usually reflected concern with little more than very immediate problems. The measures just described, nevertheless, seem to point not only to short-run considerations, but also to a constructive long-run program.

The immediate problem with which the measures were concerned was, of course, the stabilization of the value of the silver currency. This concern is evident in the reduction of the authorized coinage from 20 to 10 million pesos,<sup>29</sup> and also in the suc-

<sup>26</sup> Decree law 259 of May 28, 1934, *Gaceta Oficial* of same date. Decree laws 244, 256, and 259 contained a variety of other provisions which were summarized, clarified, and in some respects modified in decree law 410 of August 10, 1934, *Gaceta Oficial*, August 13, 1934. The gold content of the Cuban peso was reduced to 0.8886 grams fineness, in accordance with the devaluation of the dollar. The old Cuban and American gold pieces ceased to be legal tender, and the government offered to purchase them (without making their surrender mandatory, however) at a price of 35 pesos per ounce, minus 1 per cent for expenses. The newly defined Cuban gold peso (a purely theoretical unit), as well as Cuban silver pesos and American dollar bills, were made unlimited legal tender. All contracts, old and new became dischargeable only in the currency in which they had been contracted, in contrast to the provisions of decree law 244 as amended by decree law 259. Old contracts calling for payment in a medium that had disappeared from circulation (that is, Cuban or American gold) were to be discharged in American dollar bills. The exportation of gold, which previously had been restricted in varying degrees, was prohibited except for articles of personal use.

<sup>27</sup> This clause, too, was subsequently repealed.

<sup>28</sup> Decree 268, June 2, 1934

<sup>29</sup> Any suspicion that this reduction was made simply because the government did not need the money can easily be allayed by a look at the government's finances. So hard up was the Mendieta administration that on April 10, three weeks after the smaller coinage had been decreed, it became necessary to suspend sinking fund payments on the public debt.

cessive measures expanding the silver peso's range of action, which culminated in the legal tender law. But the legal tender law had much broader implications. If allowed to stand, it would have effected an almost complete separation of the Cuban and American monetary systems. By permitting all contracts, new and old, to be discharged in silver pesos, it potentially converted all internal debts into pesos and placed the domestic economy upon a peso basis. Cuba thereafter would have been able to pursue an independent monetary policy and to experience all the amenities and discomforts of a managed currency.

This liberation of the Cuban monetary system from the dollar probably was the major aim of the legislation of 1934.<sup>30</sup> Having achieved a partial success, the authorities ought logically to have proceeded to supply the island with sufficient pesos to make the use of dollars unnecessary. This probably would have caused the peso to become the common medium in all transactions and contracts, for it would have been dangerous to make dollar contracts which could not be legally upheld. The authorities, however, appear to have been without further immediate plans, or else were prevented from putting them into effect, for nothing was done. Thus the law of May 22 was left hanging in mid-air and gave rise to a very unsatisfactory situation, particularly with regard to bank credit. Banks were reluctant to lend in dollars for fear that their customers might avail themselves of their right to pay back in pesos. To satisfy all legitimate credit needs by lending exclusively in pesos was not possible, because there were not enough pesos. The banks protested bitterly, but at first to no avail, and for a while credit remained extremely tight.<sup>31</sup> Eventually, after a change in the Cabinet had taken place, the government gave in and repealed the legal tender clause.<sup>32</sup> Thereafter all new contracts were again dischargeable in the currency stipulated.

<sup>30</sup> One of the advisers of the Secretary of the Treasury stated privately that the ultimate goal was the elimination of the dollar and the creation of an independent currency and credit system, but that this policy was never formulated publicly.

<sup>31</sup> Commerce, *Latin American Financial Notes*, No. 149, p. 14.

<sup>32</sup> Decree law 410, August 10, 1934, *Gaceta Oficial*, August 13, 1934.



Thus, of the ambitiously begun monetary reform nothing remained except the full legal tender status of the silver peso in all transactions denominated in pesos.<sup>33</sup> This, however, was by no means unimportant. The peso's graduation from a subsidiary to a major currency paved the way for subsequent silver issues, which, under the pressure of budgetary needs, did not fail to materialize. The attempt to displace the dollar by a single stroke had failed, owing to poor management and adverse circumstances, but a breach had been opened through which its position was to be gradually undermined during the following years.<sup>34</sup>

The exchange-control decree of June 2 was not an integral part of the reform program, although at first sight it would seem to have fitted in well with the other measures. It was a hurriedly improvised attempt to prevent the foreign banks from exporting large amounts of dollar currency, as they had threatened to do in response to the legal tender decree.<sup>35</sup> How far the bankers would have been able to make good their threat is very uncertain, since they would thereby have exposed themselves to the danger of having to face a run without adequate reserves. The government, however, seems to have been convinced of the seriousness of the situation, as witnessed by the speed with which the exchange control decree was brought out.

The attempt at controlling the outflow of dollars, however, was a dismal failure. In part this was due to the peculiar character of the Cuban monetary system and in part to the ineffective manner in which control was carried out. The restrictions imposed were very mild. They aimed only at preventing capital

<sup>33</sup> Future references to "pesos" are to be understood to mean silver pesos.

<sup>34</sup> A minor but not uninteresting aspect of the 1934 legislation was the clause contained in the decree of May 22 under which the Cuban Treasury offered to purchase gold at 35 pesos an ounce, minus 1 per cent. Behind this lay the idea that there were considerable hoards of gold in the United States which had not been turned in under the presidential orders of April 5, August 28, and December 28, 1933, and that by creating a kind of black market for this gold in Cuba, a small reserve might be accumulated. If successful, this scheme might well have put additional pressure upon the Cuban balance of payments, since the proceeds of gold sales would probably have been withdrawn by their foreign owners. The offer, however, remained without practical consequences, since the Treasury received only negligible amounts of gold under it.

<sup>35</sup> See *New York Times*, June 5, 1934.

flight, and authorized virtually all current account transactions with the exception of tourists' expenditures, which were restricted. Export proceeds had to be repatriated within three months. For imports, dividend and interest payments, remittances of insurance companies, and several other items, general licenses were granted. The burden of administering the control and of passing on the legitimacy of transactions was placed almost exclusively upon the banks.

Since the decree described the licensed transactions only in very broad terms, and since supplementary regulations were never issued, the banks at first felt themselves unable to comply with their new duties. Their immediate reaction therefore was to suspend entirely the sale of drafts for any purpose. Thereupon the Treasury assured them that they would not be held liable for bona fide errors, and the sale of drafts was resumed on a limited scale. Doubtful cases were referred to the Treasury.

In spite of the banks' desire to ensure full compliance with the law, if only as a matter of self-protection, the opportunities for evasion were enormous. Given the exceptionally close relationships which existed between many Cuban and foreign interests, and the fact that a large part of Cuban export industries was owned abroad, funds could easily be transferred through an appropriate juggling of accounts. Even simpler than such devices was the circumvention of control through clandestine exportation of dollar currency. Since in Cuba a dollar bill constituted domestic currency as long as it remained on the island, but became foreign exchange the moment it was exported, everybody had free access to foreign exchange, without having to go to a bank or exchange dealer. It was not surprising, therefore, that within a few days after the establishment of control the smuggling of currency had assumed large proportions.

Very soon it became obvious that exchange control, instead of curbing whatever outflow of dollars might have taken place, was stimulating an active flight of capital. An attempt to tighten the restrictions not only might have failed to bring results, but would probably have met with even sharper opposition than the original law. On July 13, therefore, the government threw in the

sponge and revoked the law.<sup>36</sup> For the second time a major step toward greater monetary independence had been retraced a few days after it was first taken. Secretary of the Treasury Dr. Martínez Sáenz, who was the originator of these measures, resigned.

### 3. COMMENTS ON THE 1934 EXCHANGE CONTROL

The general implications of foreign exchange control in the Cuban economy will be taken up in the final part of this study. The 1934 control measures, however, possess certain peculiar aspects which may conveniently be discussed at this point.

In countries with independent monetary systems, exchange control in its simplest forms aims to conserve the exchange reserves which underlie the internal circulation and thus to make possible the maintenance of stable rates. In Cuba, its function was to prevent an outflow of part of the internal circulation itself. No control could be exercised over the exchange rate, since domestic conversions of pesos into dollars and vice versa could not be regulated. The exchange rate, in other words, was an internal phenomenon. These characteristics of the Cuban exchange control of 1934, arising out of the nature of the monetary system, limited its potential usefulness while also making its effective application more difficult.

In its original form, the decree failed to give adequate guidance to the banks which were to administrate it, and consider-

<sup>36</sup> *Gaceta Oficial*, July 14, 1934. The government may have been aided in reaching this decision by the attitude of the American government, which shortly after found expression in Article XI of the Trade Treaty of August 24, 1934, for which negotiations probably were in progress at that time. The article provided that "the government of each country will refrain from subjecting payments or the transfer of means of payment or the disposition thereof to any regulation, restriction, charge or exaction, other or higher than was in force on April 1, 1934, which results in (1) impairing or circumventing any provision of this agreement, (2) placing an undue burden on trade between the nationals or residents of the respective countries, or (3) preventing or hindering nationals of either country residing, doing business, or traveling in the territory of the other country, from securing and transferring in or to either country the funds reasonably necessary for, or arising from, such residence, business, or travel." This clause probably would not have interfered with Cuban exchange control insofar as the latter aimed purely at controlling capital flight, but the limitation of traveling expenses, and of withdrawals by Cubans living abroad, evidently were not compatible with the spirit of the treaty.

able confusion resulted. It is entirely possible that an attempt to work out a detailed system of regulations would have led the authorities to the conclusion that, under conditions then existing, exchange control could not be made effective in Cuba. But if they had succeeded in making it reasonably watertight, would the results have been favorable? To this question the late Professor Graham in his penetrating analysis of the Cuban monetary situation gave an uncompromisingly negative answer. "It is only by its imports that Cuba gets value for any American currency which it may hold in excess of the requirements of business at the current level of world prices. To retain such excess would be worse than folly."<sup>37</sup> This statement, nevertheless, despite its merits in principle, neglects the fact that the Cuban exchange control did not restrict imports, but aimed chiefly to prevent exports of capital. In this it probably succeeded, so far as it affected the banks, which had threatened to withdraw their dollar holdings from Cuba, but it failed dismally in coping with other types of capital transfers.

Graham recognized the injurious character of capital exports, but suggested that restrictions on the movement of currency cannot cope with this phenomenon because it might operate through different channels. He argued, "The phenomenon which is of real concern to the Cubans is not the occasional efflux of money but the steady export of capital. The latter does not necessarily, or even probably, require any outward flow of money." The Cuban exchange control, however, had guarded against the nonrepatriation of export proceeds, undoubtedly the main form of cashless capital exports, by specifically requiring the return of export proceeds within three months. Graham's comment, therefore, that exchange control would have prevented Cuba from exchanging excess currency against needed goods while failing to cope with the problem of capital exports, did not do full justice to the intentions of the 1934 decree, although it certainly was in keeping with the realities of the situation.

Another criticism to be made of the decree is that it was incompatible with the proper functioning of the monetary sys-

<sup>37</sup> Foreign Policy Association, *Problems of the New Cuba*, p. 326.

tem existing in 1934. The elasticity of the system was dependent upon the free flow of dollars in both directions. If the banks were prevented from taking dollars out of Cuba, they would, of course, have likewise refrained from bringing them in, which probably would have led to an undue restriction of credit facilities.

Thus while the attempt to control capital movements at that time probably had a good deal to commend it in principle, it evidently was not practicable within the existing institutional environment. Things would have been different if the government had carried out its original plan to create an independent Cuban currency. Under such conditions, exchange control would have lost many of its objectionable features and might, in fact, have become an important stabilizing force during the difficult transition period. Failing a thoroughgoing monetary reform, it was fortunate that control was shortly abandoned. Inasmuch as it had been designed as an emergency measure to check the outflow that threatened to develop in response to the legal tender decree, it would in any case have lost part of its *raison d'être* after the latter decree had been repealed.

It is interesting to note that the exchange rate of the peso showed remarkable stability throughout the six weeks during which exchange control remained in force. The maximum discount registered was about 1½ per cent, no more than might normally be expected at the beginning of the dead season. This, of course, does not imply that there was no pressure to convert pesos into dollars. There almost certainly must have been individuals who sold pesos in order to acquire dollars for the purpose of clandestine exports. Others may have sold pesos because of the growing uncertainty as to the future of the Cuban currency. The relative firmness of the peso does, however, attest to the effectiveness of the market forces that tended to keep it at par.<sup>38</sup>

<sup>38</sup> Graham pointed out that a possible consequence of a really watertight exchange control might have been the depreciation of dollars in Cuba against dollars in New York. If the development potentially anticipated by Graham had materialized, the peso would certainly have fallen at least in the same proportion against New York dollars. A decline against Havana dollars would not necessarily have resulted, however. See Foreign Policy Association, *Problems of the New Cuba*, p. 325.

## 4. INTRODUCTION OF SILVER CERTIFICATES

The inconvenience involved in handling large amounts of heavy silver currency, which was one of the contributory causes of the discount, made the introduction of a more practical medium desirable. As early as May 1933, in connection with the coinage of 6 million silver pesos, the Machado government had provided for the issuance of silver certificates, which failed to materialize owing to the change in government. The decree authorizing the Mendieta government's first 10-million-peso issue early in 1934, however, also authorized the issuance of an amount of certificates, to be circulated in place of the coins.<sup>39</sup>

These certificates made their first appearance in February 1935. The government approached their issuance with the utmost caution and took every care to allay public mistrust. The law provided that the certificates were to be fully backed by peso coins deposited with the Treasury, and that they were to be convertible upon demand. Certain sectors of the public nevertheless feared that under the pressure of budgetary needs the silver reserve might eventually be placed in circulation side by side with the certificates. The government therefore evolved an elaborate procedure for safeguarding the collateral. A commission consisting of two cabinet members and various representatives of the business community was created to watch over the fulfillment of all legal requirements.<sup>40</sup> Four times a year the commission was to make an inventory of the silver reserve. In order to prevent clandestine withdrawals, the certificates and the silver were deposited in a vault with two combinations, one of which could be operated only by one of the business members of the commission.

None of these safeguards of course went very far, since nothing could prevent the government from changing the law. The fears of the pessimists remained unfounded, however, and the silver collateral remained safely in the Treasury. The certificates, which were introduced with the aid of the banks in Febru-

<sup>39</sup> Decree law 93, March 22, 1934, *Gaceta Oficial*, March 23, 1934, as amended by decree law 176; April 27, 1934, *Gaceta Oficial*, April 28, 1934.

<sup>40</sup> Decree law 161, January 26, 1934, *Gaceta Oficial*, January 30, 1935, as amended by decree law 211, February 1, 1935, *Gaceta Oficial*, February 2, 1935.

ary 1935, were an immediate success. Thereafter, every new silver coinage was accompanied by an equivalent issue of certificates which were put into circulation, while the coins never left the Treasury. Additional certificates were issued to replace the peso coins placed in circulation in 1934 and earlier. Only a small amount of coins eventually remained in the hands of the public. The details of these operations are shown in Table 5.

TABLE 5  
PESO ISSUES, 1932-1939  
(In thousands)

| Date *         | Silver                | Silver<br>certificates | Nickel | Silver<br>seigniorage | Gold    |
|----------------|-----------------------|------------------------|--------|-----------------------|---------|
| February 1932  | 3,586.9               | ..                     | ..     | 2,695.7               | ..      |
| February 1933  | 6,000.0               | ...                    | ..     | 4,192.9               | ..      |
| March 1934     | 10,000.0              | 10,000.0               | ..     | 6,170.8               | ...     |
| November 1934  | 10,000.0              | ..                     | ..     | 5,546.9               | ..      |
| September 1935 | 10,000.0              | 10,000.0               | ...    | 4,685.8               | ...     |
| February 1936  | ...                   | 10,000.0               | ...    | ..                    | ..      |
| June 1936      | 20,000.0              | 20,000.0               | ...    | 12,592.2              | ...     |
| June 1938      | 20,000.0              | 37,000.0 <sup>b</sup>  | 20.0   | 12,707.5              | ..      |
| 1939           | ...                   | ...                    | ...    | ...                   | 1,240.7 |
|                | 79,586.9 <sup>c</sup> | 87,000.0               | 20.0   | 48,591.8              | 1,240.7 |

\* Date on which issue was authorized. The Cuban Treasury statistics of peso issues, which are not shown here, are arranged according to the time when the money was placed in circulation, which accounts for the divergence of the latter for individual years.

<sup>b</sup> Of this amount, 5 million pesos was reserved for the exchange of unfit currency and 12 million for the eventual retirement from circulation of the 12 million silver pesos issued by the end of 1932. An amount of 1,240,712 pesos was issued in 1939 against an equivalent amount of gold coins (bullion value) which had accumulated in the Treasury.

<sup>c</sup> The total amount of silver coins, including those issued before 1932, was 88 million pesos.

Source. *Cuba Económica y Financiera*, May 1939, p. 30.

## 5. ANALYSIS OF ORIGIN OF MONEY SUPPLY

The developments of the thirties brought about substantial changes not only in the composition of the money supply — in the form of a rising proportion of peso currency and deposits, but also in its volume and origin. From a high of 260.6 million in 1926, the volume of money had come down sharply to 110.1 million dollars/pesos in 1932 and had reached its low at 101.1 in 1934. From then on a fairly steady recovery took place to a temporary high of 143.4 in 1937. It is noteworthy that the de-

pression into which Cuba relapsed from 1938 to 1940 did not cause a very substantial shrinkage in the money supply. A slight dip in 1938 was followed by a quick resumption of the upward trend, destined eventually to degenerate into the violent wartime expansion which drove the money supply up at annual rates of increase which exceeded the total supply during the early depression years.

These quantitative changes in the money supply were accompanied, and in varying degree determined, by important structural changes in its origin. Prior to the initiation of the silver policy in 1932, practically all of the Cuban money supply had come into existence either through private bank credit or through the inflow of funds from abroad. In the absence of a central bank, the only credit money creation on the part of the government had been that implicit in the seigniorage on the pre-1932 silver and other fractional currency issues.<sup>41</sup> The most significant change in the origin of the money supply after 1932 is the rapid and steady increase in Treasury credit money, as the result of successive silver issues. To each silver coin — or the certificate circulating in its place — a twofold monetary origin must be assigned: the proportion corresponding to its bullion value was of international origin, while the seigniorage part represented Treasury credit money. During the years 1932–1939, the Treasury issued 79.6 million in silver, the bullion cost of which was not quite 31 million dollars. The difference, together with the seigniorage on the small issues in 1914–15 and 1920 represented the credit money creation of the Treasury.<sup>42</sup> By the end of 1939, the Treasury in this form had made a net addition of 53.5 million to the money supply (see Table 6).

Quantitatively even more important as a determinant of the money supply were changes in the volume of bank credit. Between 1930 and 1936 an enormous shrinkage took place, carry-

<sup>41</sup> The gold coins issued by the government, being full-bodied, involved no credit creation, but were wholly of "international" origin.

<sup>42</sup> Fluctuations in the market price of silver have produced corresponding changes in the bullion value of the silver currency. This would become important if the Cuban government should decide to sell the silver reserve and replace it with gold or foreign exchange. For the analysis of the origin of the money supply, however, and for the study of the economic effects of the Treasury's money creation, only the cost price of the silver and the resulting seigniorage are relevant.



TABLE 6  
MONEY SUPPLY BY ORIGIN, 1930-1941  
(In millions)

| End of | Money Supply                        |                |                      |                                                          |              |                                                        |                              |                                                      |       |      |                                 | Money of<br>International<br>Origin,<br>per cent<br>of total |                  |
|--------|-------------------------------------|----------------|----------------------|----------------------------------------------------------|--------------|--------------------------------------------------------|------------------------------|------------------------------------------------------|-------|------|---------------------------------|--------------------------------------------------------------|------------------|
|        | Credit Origin                       |                | International Origin |                                                          |              |                                                        |                              |                                                      |       |      | Total<br>(1 + 5 + 6<br>+ 7 + 8) |                                                              | Total<br>(3 + 9) |
|        | Treasury<br>credit<br>(seigniorage) | Bank<br>credit | Total<br>(1 + 2)     | Bullion<br>value of<br>silver,<br>nickel &<br>other coin | Gold<br>coin | Gold<br>bullion &<br>dollars<br>backing<br>silver cert | Dollars<br>in<br>circulation | Dollars<br>in banks<br>and net<br>balances<br>abroad |       |      |                                 |                                                              |                  |
| (1)    | (2)                                 | (3)            | (4)                  | (5)                                                      | (6)          | (7)                                                    | (8)                          | (9)                                                  | (10)  | (11) |                                 |                                                              |                  |
| 1930   | 4.9                                 | 110.1          | 115.0                | 5.0                                                      | 20.3         |                                                        | 38.5                         | 45.9                                                 | 100.9 | 28.5 |                                 |                                                              |                  |
| 1931   | 4.9                                 | 100.4          | 105.3                | 5.0                                                      | 16.6         |                                                        | 39.6                         | 27.6                                                 | 132.9 | 20.8 |                                 |                                                              |                  |
| 1932   | 7.6                                 | 83.3           | 90.9                 | 5.9                                                      | 11.3         |                                                        | 25.0                         | 10.2                                                 | 110.1 | 17.4 |                                 |                                                              |                  |
| 1933   | 11.8                                | 74.7           | 86.5                 | 7.7                                                      | 6.3          |                                                        | 31.4                         | 21.3                                                 | 107.8 | 19.8 |                                 |                                                              |                  |
| 1934   | 18.0                                | 58.5           | 76.5                 | 11.4                                                     | .7           |                                                        | 25.0                         | 24.6                                                 | 101.1 | 24.3 |                                 |                                                              |                  |
| 1935   | 24.1                                | 43.9           | 68.0                 | 17.3                                                     | .2           |                                                        | 20.1                         | 38.9                                                 | 106.9 | 36.4 |                                 |                                                              |                  |
| 1936   | 32.6                                | 15.7           | 48.3                 | 23.8                                                     | .2           |                                                        | 15.4                         | 73.3                                                 | 121.6 | 60.3 |                                 |                                                              |                  |
| 1937   | 40.8                                | 28.6           | 60.4                 | 28.6                                                     | .1           |                                                        | 14.2                         | 74.0                                                 | 143.4 | 51.6 |                                 |                                                              |                  |
| 1938   | 47.4                                | 20.1           | 73.5                 | 32.4                                                     | .1           |                                                        | 12.7                         | 65.7                                                 | 139.2 | 47.2 |                                 |                                                              |                  |
| 1939   | 53.5                                | 36.7           | 90.2                 | 36.0                                                     | .1           | 1.2                                                    | 14.2                         | 56.6                                                 | 146.8 | 38.6 |                                 |                                                              |                  |
| 1940   | 53.5                                | 40.7           | 94.2                 | 36.0                                                     | 1            | 1.2                                                    | 19.4                         | 60.0                                                 | 163.2 | 42.3 |                                 |                                                              |                  |
| 1941   | 53.5                                | 30.9           | 84.4                 | 36.0                                                     | .1           | 1.2                                                    | 29.4                         | 108.0                                                | 192.4 | 56.1 |                                 |                                                              |                  |

Sources See Tables 1, 4, 13

ing that part of the money supply which had its origin in bank credit from 110.1 million down to 15.7 million. During the depression of 1938-1940, there was a recovery in the volume of money originating in bank credit, which was soon to vanish again, however, in consequence of the war boom.

Only a small part, however, if any, of the great contraction since 1930 reflects changes in the current credit policy of the banks. Much of it was accounted for by collection or write-offs of credits that for many years had been frozen. Part of the contraction also was due to the public's tendency, during this period, to convert demand deposits into time deposits, the resultant reduction in the money supply finding statistical expression in a reduction in bank credit as a source of money, without any change in the volume of bank loans.<sup>43</sup> A reverse flow from time to demand deposits during the years 1938-1940, rather than a countercyclical expansion of bank loans, was mainly responsible for the temporary rise in bank credit money during those years. A fuller discussion of the role of bank credit in the monetary picture will be found in the chapter dealing with bank policies.

It will be noted that during the years 1932-1936 the decline in money of bank credit origin, amounting to 67.6 million, was compensated only in small part by the increase in money of Treasury credit origin, which was no more than 25 million. That the total money supply over the period nevertheless showed a rise of 11.5 million was due to the increase in money of international origin, produced by the active balance of payments.

Cuba's net international reserves at the beginning of the period were extremely low, which is somewhat surprising in view of the existence of a substantial dollar circulation forming part of the money supply of international origin.<sup>44</sup> This is ex-

<sup>43</sup> When the public decides to hold the deposits created by bank loans in the form of time deposits, which are regarded as not forming part of the money supply, the banks' credit creation evidently has not led to an increase in the money supply. It has been sterilized by the public's action of converting demand deposits into time deposits.

<sup>44</sup> Part of the decline in money of international origin between 1930 and 1933 is due to the outflow of gold that is assumed to have taken place during those years. It is conceivable that this outflow had already been consummated during the twenties — no statistics are available — in which case the international money supply figures for 1930-1933 would be correspondingly lower.

plained, however, by the heavy indebtedness of the foreign banks to their head offices. These overdrafts, representing short-term international liabilities, must be deducted from gross international assets in order to arrive at the net international reserves upon which the money supply of international origin is calculated. These liabilities were worked off before 1935, taking the banking system as a whole. A good part of the repayment took place, as said before, not through an export of capital from Cuba, but by the writing off of loans against reserves transferred to the foreign banks from their head offices.

The money supply of international origin dipped somewhat with the downturn of the cycle in 1938 and 1939, but soon after initiated an expansion which in 1944 assumed virtually explosive characteristics. The increase in the total money supply during the war years was almost solely the result of the international factor, for Treasury credit creation was negligible and money of bank credit origin actually declined, again owing to a rapid rise in time deposits.

This analysis of structural changes in the origin of the money supply confirms the view repeatedly stressed in the present study, that the balance of payments is the main determinant of monetary conditions in Cuba. The fact that during the early and middle thirties the change in money of bank credit origin exceeded that produced by the two other factors does not contradict this view. The reduction in bank credit represented largely the liquidation of loans of an earlier boom period. While the data available for that period do not permit an investigation of the type here presented, they do make clear that the balance of payments then, as later, was the main determinant of the money supply.<sup>45</sup>

<sup>45</sup> The data shown in Table 6 are year-end figures and therefore do not show the seasonal loan expansion resulting from the financing of the sugar crop, which reaches its climax in the spring. It is appropriate, however, to neglect this seasonal expansion, since it merely represents the prefinancing of future exports. Any permanent increase in the money supply resulting from a large sugar crop is properly shown as of external rather than internal origin.

## CHAPTER V

### THE ELEMENTS GOVERNING THE EXCHANGE RATE OF THE PESO

WITH THE INTRODUCTION of silver certificates early in 1935 the flood of monetary innovations which began in 1932 came to a temporary halt. Although successive peso issues and the growth of peso deposits during the next few years altered the composition of the Cuban money supply in favor of the peso, no further institutional changes occurred until 1938. Peso and dollar circulated side by side, and during the entire period the discount on the former never exceeded 2 per cent. Generally, in fact, it was only a fraction of 1 per cent. The forces which determined the rate, through an interaction of Gresham's Law and the balance of payments mechanism, will be discussed in this chapter.

#### I. GRESHAM'S LAW

Gresham's Law presupposes two markets, in which two kinds of money are valued at different ratios. Normally these markets are geographically separated, but in the Cuban situation this was not the case. Both "markets" were located within Cuba and their segregation depended upon economic, not locational factors. We may call them the internal and the external market, without attaching too literal a significance to these terms. The limits of the two cannot, of course, be precisely defined. The internal market may be regarded as the sphere of the public's small day-to-day transactions, such as retail purchases and personal services, and the sphere of tax and wage payments. One may also define it as the sphere wherein money was looked upon primarily (but of course not exclusively) in its character as a "medium of exchange" rather than that of a "store of value." In the internal market no direct sales of dollars against pesos

took place. The relative values of the two currencies in this market, which during most of the period under discussion were identical, found expression merely in their respective purchasing powers. Exchange transactions of pesos against dollars were carried on only in the external market. The latter encompassed most of the transactions of business firms, banks, and wealthy individuals. In this market the "store of value" aspect of money was as important as its "medium of exchange" character. To avoid misunderstanding, it is important to emphasize that the two markets were not foreign exchange markets, but markets for all goods and services, and that foreign exchange transactions formed only a small segment of the external market.

It is evident why the peso tended to be valued lower relative to the dollar in the external market than in the internal. Holders of substantial cash balances naturally preferred the currency which possessed greater stability. Although the stability of the dollar was not beyond question, as the year 1933 had demonstrated, it was morally certain that a renewed depreciation of the American unit would again carry the Cuban with it, while the peso, on the other hand, might very well depreciate against a stable dollar. American and Canadian firms, moreover, inevitably were partial to the dollar, if for no other reason than that it was their home currency. Importers, finally, found dollars more convenient because their purchases were generally billed in that currency. The resulting preference for dollars tended to drive the peso to a discount in relation to its valuation in the internal market, where it suffered less from these handicaps.

Under these circumstances, Gresham's Law naturally came into operation. As long as the peso's value in the external market was substantially below that in the internal, a holder of dollars about to make a purchase in the latter market could save money by converting them into pesos. Since the volume of peso currency and deposits was insufficient for the needs of the internal market, the peso rate in the external market tended to be driven up to a point where the saving ceased to be significant. The result was that pesos tended to be drawn into the internal market while dollars in excess of the amount needed to make up the deficiency were driven out, and that the value of the peso

in the external market ordinarily remained within a fraction of one per cent of that prevailing in the internal.

Since the two markets were both located in Cuba, their distinction being functional rather than geographical, Cuba did not lose dollars as the immediate result of the workings of Gresham's Law. Pesos could not be imported from abroad, and dollars in general, therefore, could flow out only if a passive balance of payments developed. Such a balance was of course a possible consequence of the seigniorage policy, because the latter tended not only to increase imports by expanding the money supply and stimulating national income, but also to create uncertainties leading to capital flight. These developments, however, are not directly related to the operation of Gresham's Law.

The application of Gresham's Law to the Cuban situation serves to explain why the valuations of the peso in the internal and the external market could not move very far apart. As long as the peso (both currency and deposits) failed to cover the needs of the internal market and had to be supplemented with dollars, there was always a demand for pesos sufficient to prevent a spreading of the rates in the two markets. Gresham's Law does not explain, however, why in the internal market the peso remained at par with the dollar. An example will make this clear. One might conceive of a situation where the purchasing power of the peso in the internal market had fallen to the equivalent of \$0.50. In that case, Gresham's Law would operate to keep the peso in the external market at perhaps \$0.49¾, or whatever discount from \$0.50 would be small enough to permit the dollar to be used in the internal market at the latter rate. The demand for pesos would become stabilized as soon as the two rates had come sufficiently close together, and no rise against the dollar would have to be anticipated.<sup>1</sup>

<sup>1</sup> Situations where a depreciated and a sound currency have circulated side by side are not unknown. The German inflation after the First World War, where the quotation of the dollar finally came to rule retail prices, and dollars actually circulated, is a case in point. The possibility of such a situation hinges upon a close adjustment of exchange rates between the two markets where Gresham's Law is operative, so that there is no advantage in withdrawing or hoarding the "better" money.

The factors which prevented such a development seem to have resided in institutional peculiarities. The forces of habit and convenience no doubt went far to prevent the dollar from achieving a premium in the internal market. Retailers normally fixed their prices in pesos and in doing so made allowance for the small loss which would result from converting pesos into dollars in order to pay for imported goods. If a customer paid in dollars, the retailer did not reduce the price, but pocketed the small margin. To do otherwise would have been inconvenient, and in most instances not worth the trouble of making the calculation. When in 1939 the premium on the dollar in the external market had become so large that it could no longer be ignored in the internal, the dollar simply vanished from the internal circulation.

## 2. SIGNIFICANCE OF THE BALANCE OF PAYMENTS

The preceding analysis has abstracted from the effect which autonomous changes in exports and investment might have upon the volume of dollars in Cuba. Attention was centered on the effects of new peso issues, and it was implicitly assumed that the composition of the money supply in the internal market was not affected by other factors. Under these conditions an increase in the volume of pesos must necessarily cause an absolute reduction in the volume of dollars in that market. It is conceivable, however, that a simultaneous increase in exports or investment might so stimulate business activity that the resulting need for additional means of payment would not be met by the newly created pesos. In that case dollars would be drawn into the internal market, instead of being displaced from it.<sup>2</sup> Thus, while the effect of new issues, regarded in isolation, would always be to drive dollars out of the internal market, it might be offset by independent factors, particularly by the balance of payments. The volume of dollars in the internal market, therefore, was to some extent dependent upon the balance of payments.

<sup>2</sup> If the stimulus was derived from new investment, the aggregate supply of dollars in the two markets would diminish, owing to rising imports, but dollars would nevertheless have to be shifted from the external into the internal market, in order to meet the latter's monetary requirements.

Through its influence upon the monetary requirements of the internal market, the balance of payments in turn influenced the exchange rate of the peso. Two situations must be distinguished in this connection. The first is that which prevailed before 1939, and again after 1940, when dollars and pesos circulated jointly in the internal market. The second is that of the years 1939 and 1940, when the monetary requirements of that market were covered almost exclusively by the peso.<sup>3</sup> While dollars remained in circulation, the demand for pesos possessed virtually perfect elasticity, and the balance of payments could induce fluctuations in the rate only within very narrow limits. When the peso circulation passed the saturation point, however, which happened sometime in 1938, the second stage was reached. The dollar disappeared from the internal market, the forces which before had kept the peso close to par ceased to operate, and the peso was "on its own." At that point the balance of payments began to acquire major significance.<sup>4</sup>

Even then, however, the balance of payments did not completely dominate the peso rate, and its influence was not of a direct character, as it would be in a free exchange system.<sup>5</sup> Although the peso currency during the years 1939 and 1940 bears a certain resemblance to such a system, an analogy derived from this superficial similarity is misleading, because it fails to take into account the continued use of dollars in the external market. Under a free exchange system, all balance of payments transactions either involve exchange transactions or at least have a direct bearing upon the exchange market, by

<sup>3</sup> The events of the years 1938-1947 are here anticipated in order to preserve the continuity of the analysis. A detailed description of the happenings of this period will be found below.

<sup>4</sup> One might add that previously the balance of payments had had a certain significance in that, by speeding up or delaying the displacement of dollars from the internal market, it influenced the approach of the second stage.

<sup>5</sup> It is agreed, of course, that in a free exchange system, the balance of payments is not the ultimate causal determinant of the exchange rate, but merely the focus where the basic factors, such as prices, incomes, etc., become effective. All that the above statement implies is that in a free exchange system the balance of payments determines the rate in the same manner in which demand and supply determine price.



altering demand and supply conditions.<sup>6</sup> In Cuba balance of payments transactions and exchange transactions were not synonymous. Many of the former involved only operations in Havana dollars against New York dollars, which did not affect the peso, while sales of Havana dollars against pesos had nothing to do with the balance of payments.

In an immediate sense, therefore, the peso rate, as pointed out before, was determined solely by the monetary needs of the internal market and by speculative demand for pesos in the external sphere. The balance of payments undoubtedly was the most important determinant of both of these factors, but it was not the only one, and its effect was capable of being offset by other factors. One could conceive, for instance, of a situation where the peso might depreciate in spite of an active balance, because of a simultaneous contraction of domestic investment and a resultant decline in the monetary requirements of the internal market. One could envisage likewise an appreciation of the peso in the face of a passive balance, if expanding investment should create a sufficiently strong demand for means of payment.<sup>7</sup> The same paradoxical phenomenon of a passive balance associated with a rise in the peso might also occur in anticipation of a good sugar crop. Preparations for the crop would cause an expansion in business, while the balance of payments might deteriorate because importers would be stocking up in expectation of greater demand. Something of this kind may have happened in 1940, when the trend of imports turned upwards several months in advance of exports. It is only in the absence of these (admittedly unusual) counteracting forces that the bal-

<sup>6</sup> An export of merchandise, for instance, does not involve an exchange transaction, if the proceeds are not repatriated, but the failure to repatriate, which implies an export of capital, reduces the supply of foreign exchange and weakens the local currency.

<sup>7</sup> In the latter instance, it is assumed, of course, that the new investment is made with domestic funds, for an inflow of foreign investment funds of the required magnitude would be inconsistent with the assumption of a passive balance of payments. The argument also assumes that there is no increase in the peso currency, or in the peso loans of the banks, since otherwise the rise in monetary requirements could be satisfied without causing an additional demand for pesos in terms of dollars.

ance of payments becomes the exclusive determinant of the peso rate, whenever the dollar has been driven from the internal market.

The preceding analysis of the qualitative determinants of the peso rate, however, does not say very much as to their quantitative effects. How great a change in the effective circulatory requirements of the internal market would be produced by, for instance, an annual passive balance of ten million pesos, not offset by any other factor? The answer lies (1) in the effect upon the volume of business, (2) in the change in circulatory requirements resulting from a decline in business, and (3) in the general state of confidence. Given Cuba's unusually low marginal propensity to consume home-produced goods, and hence her low multiplier, the contraction in business resulting from a given passive balance is likely to be relatively small. How far the contraction affects the need for peso balances it is impossible to say, for this need undoubtedly is quite flexible. In this context the state of confidence is important. If significant depreciation is anticipated, the public probably will be able to get along with considerably smaller balances than would be necessary under normal circumstances. Thus the effective circulatory requirements would shrink not only in the proportion warranted by the decline in business, but by a further amount determined by the public's willingness to accept inconvenience rather than risk. Needless to say, it is extremely difficult to assign numerical values to any of these factors.

## CHAPTER VI

### THE THREE MORATORIA

BEFORE WE RETURN to the discussion of monetary developments, it is necessary to review, by way of digression, the mortgage moratoria of 1933, 1934, and 1940. These moratoria, like the monetary problems discussed so far, were an outgrowth of the depression and must be regarded as an integral part of the monetary picture, because in design and effect they constituted an alternative to exchange depreciation.

The first moratorium was instituted by the Machado government on April 3, 1933, when the depression was at its worst.<sup>1</sup> It suspended all interest and amortization payments on the mortgage obligations of the railroads, the Banco Territorial de Cuba, the sugar companies, and all other Cuban industries until July 1, 1935.<sup>2</sup> Amortization on rural and urban real estate mortgages was also suspended, but interest payments up to 2 and 4 per cent respectively were to be maintained. The rentals of cane properties were reduced by 35 per cent for the duration of the international sugar control scheme to which Cuba had adhered. All payments suspended under the moratorium were to be made up in three annual installments, due on the first of July of 1935, 1936, and 1937. Debts which were in default before the moratorium as well as those incurred subsequently remained unaffected.

This first moratorium was followed by a much broader one promulgated by the Mendieta government on August 14, 1934.<sup>3</sup> In addition to the obligations covered in the preceding measure, the 1934 moratorium also included certain agricultural loans,

<sup>1</sup> *Gaceta Oficial*, April 4, 1933.

<sup>2</sup> Sugar companies whose mortgage contracts had been established abroad (chiefly under indentures of bonds issued in the United States) remained unaffected.

<sup>3</sup> *Gaceta Oficial*, August 14, 1934.

loans on sugar and on shares of sugar companies, liabilities of firms or persons whose assets had become illiquid owing to the moratorium, and a series of other obligations. The duration of the moratorium was extended until June 30, 1942. Installments covering 20, 35, and 45 per cent of accumulated interest and amortization were to fall due on June 30 of 1940, 1941, and 1942, respectively. Sugar companies, in addition, were required to make annual payments after July 1, 1936, the amount of which was based upon the value of their sales and the price of sugar. With these measures the government hoped to forestall "an auction sale, under catastrophic conditions, of a large share of Cuban property."<sup>4</sup>

The heaviest blow to creditor interests was still to come, however, for the terms of the 1934 moratorium were once more extended and broadened by the provisions for the "liquidation of the moratorium" which formed part of the constitution adopted on July 5, 1940.<sup>5</sup> All secured obligations up to August 1934 were included, and debts incurred between that date and September 1937 in the purchase of sugar properties likewise became subject to the new law. All interest accrued up to date was canceled, and new rates were fixed ranging from 3 per cent on debts not exceeding 15,000 pesos to 1 per cent on those over 800,000. Amortization was to take place over twenty years in case of debts of 1,000 pesos or less, and over thirty years for amounts over 50,000. Interest and amortization payments on debts secured with sugar properties were to be suspended whenever the price of sugar fell below 1.40 cents per pound, but the rate of amortization was to be stepped up with rising sugar prices. Thus the moratorium was in effect extended until 1970.

A moratorium such as the Cuban is one of several alternatives which may be resorted to when a country's economy threatens to bog down under a burden of private debts. The simplest alternative is to let nature take its course and permit insolvent debtors to go through bankruptcy, thus wiping out part of the debt structure. A second possibility is the extension

<sup>4</sup> Preamble to the moratorium of August 14, 1934, *Gaceta Oficial* of same date.

<sup>5</sup> *Ibid.*, July 8, 1940, Transitory Provision to Title 4.

of government support to weak debtors through emergency loans. Another is the reduction of the debt burden through currency depreciation, with attendant price inflation. In recent years the tendency has clearly been away from the laissez-faire policy of debt liquidation through bankruptcy, and toward government intervention in one form or another. Granted that the debt burden of the Cuban economy had become insupportable, would one of the alternative solutions have been preferable to a moratorium?

A thorough liquidation of an overgrown debt structure has often been regarded as healthy, although painful, because it serves to eliminate incompetent entrepreneurs and "wipes the slate clean." The process, however, is costly, for it may take a long time before all that is torn down can be rebuilt. In Cuba, where an uncertain economic future tended to weaken private initiative, many enterprises, once liquidated, might never have been replaced. A policy of liquidation, moreover, has generally been recommended only as an antidote to previous overexpansion. In 1933, Cuba's last period of expansion lay seven or eight years behind. What was threatening in 1933 was not an immediate reaction from a preceding boom, but the climax of a secondary depression, after a long period of contraction.<sup>6</sup> In such a situation, large-scale liquidation was justifiable only if the existing low level of prices was accepted as permanent, and hope for a return to higher levels had to be given up. That adaptation to a lower price level was inevitable and had not yet been carried through sufficiently was the view of *Cuba Económica y Financiera*, one of Cuba's leading economic periodicals. On this ground the magazine criticized the moratorium as tending merely to postpone the problem, without solving it.<sup>7</sup> Events proved that this view was not entirely wrong. Conditions in Cuba in 1933 and 1934, nevertheless, were so extremely depressed that some measure of improvement could almost certainly be expected. Rigorous liquidation, therefore, would have wiped out mortgage-burdened equity interests that, with some improvement in conditions, could have been preserved.

<sup>6</sup> For an analysis of this distinction, see Wilhelm Roepke, *Crisis and Cycles* (London, 1936), pp. 119-134.

<sup>7</sup> *Cuba Económica y Financiera*, August 1934, p. 10.

A further consideration was the fact that large-scale liquidation was certain to cause many Cuban properties to pass into the hands of foreign creditors, primarily into those of the banks. This had been amply demonstrated during the crisis of 1920-21. Although on that occasion the government had likewise attempted to stem liquidation by declaring a moratorium, the method of lifting the moratorium had enabled, and to some extent forced, foreign interests to take over numerous assets previously owned by their Cuban debtors. It is true that a policy of permitting sugar properties to be put through the wringer might have had certain advantages for Cuba, for lower fixed costs might have improved the island's competitive position in the international sugar market. But liquidation in the sugar industry had been quite severe as it was, and the further alienation of the industry would have been a very grave matter for Cuba. To the extent, moreover, that the industry already was in foreign hands, the reorganization of insolvent concerns was largely a matter to be settled between foreign stockholders, foreign bondholders, and foreign banks, and usually was not within the province of the Cuban government. All in all, therefore, one may say that the Cuban government did well in blocking the process of liquidation that would have been the consequence of a *laissez-faire* policy.

Whether the moratorium was the best method of arresting liquidation, or whether governmental emergency loans, or exchange depreciation, had they been within the realm of practical possibilities, would have been preferable, is much less certain.<sup>8</sup> As compared with depreciation, the moratorium had the advantage that its incidence could be localized. It did not involve a complete revaluation of all contracts, but could be limited to certain classes of debts.<sup>9</sup> Moreover, the moratorium did not produce a permanent alteration in the value of debts,

<sup>8</sup> Both alternatives are somewhat academic, since they would have required a prior change-over to a pure peso system, perhaps with a central bank through which emergency loans could have been financed.

<sup>9</sup> The significance of depreciation is not limited, of course, to the relief it affords to the debtor classes. Its impact upon foreign trade, wages, and the cost of living may be much more important. These aspects are discussed in Part IV, Chapter XIII. At this point, however, depreciation is considered merely insofar as it constitutes an alternative to a moratorium.

such as would have resulted from depreciation, but maintained (or at least was supposed to maintain) the status quo. To the extent that existing conditions were regarded as exceptional this was evidently desirable.

As compared with governmental emergency loans, the moratorium had the advantage of greater cheapness and simplicity. Although by means of loans the government would have been even better able to control the incidence of relief, giving aid where it was needed, withholding it where it was not, this method might easily have led to abuses.<sup>10</sup> Politically powerful interests could have secured easy loans, and the project might have developed into a raid upon the public purse. Moreover, such a project would probably have forced the government to acquire and operate foreclosed properties, for which it was hardly equipped.<sup>11</sup>

The advantages of a moratorium over other relief measures must be weighed against certain very serious drawbacks. Insofar as entrepreneurs are the chief beneficiaries of a moratorium, its effect is likely to be stimulating. But this is accomplished at the expense of savers and investors. If the latter are treated too roughly, the flow of capital will be shut off, and the stimulus to enterprise will evaporate. Precisely this was the effect of the Cuban moratorium. Cuban capitalists on the whole had never been particularly venturesome. Many of them habitually transferred part of their investible funds abroad. Within Cuba, their favorite investments, with the exception of the sugar industry, had been real estate mortgages, which seemed to offer a maximum of safety combined with a high return. Now, under the moratorium, their caution turned out to have been useless. Their capital was frozen, and the return, if any, was cut by 50 to 75 per cent. The inevitable result was a shrinkage in the supply of local capital.

<sup>10</sup> The moratorium procedure also was by no means immune to such dangers.

<sup>11</sup> The Cuban government owned and at times operated the central Limones, which it had acquired in partial settlement of its claims on the defunct Banco Nacional. In 1942 central Limones was given to the National University, as a means of securing revenue for the latter. The government's record of administrative achievement has not been particularly encouraging, although, as the Foreign Policy Association has pointed out, this may have been due to the central's unfavorable competitive position (*Problems of the New Cuba*, p. 229).

The damage might not have been too great, had the terms of the original moratorium been adhered to. If the government had permitted regular payments to be resumed after July 1935, creditors might on the whole have gained from the moratorium and their confidence might have been restored. Unfortunately, however, the moratorium began to feed on itself, and tended to prolong the conditions that it was to have remedied. Many debtors, instead of preparing for a resumption of payments within two years, merely adjusted their budgets to the reduced burden of fixed charges. Political pressure developed, particularly against the foreign banks, and the government was prevailed upon to decree a second moratorium, after the first had barely passed its halfway mark, with a broader coverage and a greatly extended duration.

Only very inadequate justification for this move can be found in the fact that economic conditions had not improved so much as the optimistic hoped, particularly since a fair measure of improvement undoubtedly had taken place. That many debtors would not be able to meet their obligations in 1935, no matter how hard they tried, was obvious even in 1933 and should certainly not have been regarded as making an extension imperative. The moratorium was an emergency measure, the duration of which had to remain strictly limited if harmful consequences were to be avoided. Instead, however, it was converted practically into a standing feature. The banks were particularly hard hit under the second moratorium. The first had dealt comparatively mildly with them, in keeping with the policy of the Machado administration, and had not affected obligations of the type that constituted the bulk of their assets. The second, however, embraced sugar loans, which were the banks' special province, and caused them considerable embarrassment. The extension granted in 1940 perpetuated this situation.

Thus Cuba paid a heavy price for relief from deflation. Her rudimentary capital market was greatly weakened, particularly the market for mortgage credit. Prospects for creating a domestic market for government securities faded. The banks' lending policies became even more cautious than before. The



intensified export of savings began to press more heavily upon the balance of payments and tended to weaken the currency.<sup>12</sup>

The evil effects of the moratoria were eventually remedied, to some extent, by the wave of liquidity and rising prices that engulfed Cuba during the Second World War. The banks found it possible to liquidate many of their frozen credits, and investors, hard pressed to find outlets for their swollen cash balances, began to take a more optimistic view of mortgage and other risks. The fact remains, however, that a rather dubious precedent was set by the moratoria policy of the thirties, one which may be resorted to again when the pressure recurs.

On the whole, one cannot avoid the conclusion that alternative solutions to the debt problem, via governmental lending or depreciation, would probably have involved less heavy economic costs and would in many respects have been preferable.<sup>13</sup> The execution of these policies would have called for the creation of an independent Cuban monetary system and the conversion of internal dollar obligations into pesos, aims that the abortive reforms of 1934 had endeavored to accomplish. Had the reforms been followed through to their logical conclusion, the renewal of the moratorium in 1934 might have been avoided. It is significant that this renewal was decided upon soon after the more far-reaching aspects of the monetary reform program had been abandoned.

To conclude these comments on the moratorium episode: The severest critics of the moratorium have been those who also were most strenuously opposed to expansive central bank projects and to depreciation. It must be recognized, however, that these three policies were alternatives. At least one of them (or perhaps expansion and depreciation together) had to be accepted, for it was neither politically feasible, nor economically

<sup>12</sup> It is noteworthy how two successive depressions have left their imprint with particular force upon the Cuban credit system. The 1920-21 crisis destroyed the native banks, and the depression of the thirties wrecked the capital market.

<sup>13</sup> The government itself probably would have preferred to make emergency loans, had they been feasible. The preamble to the 1934 moratorium speaks of the desirability of monetary expansion and states that in view of the impossibility of bringing it about, owing to the lack of an appropriate instrument, resort must be had to a moratorium.

desirable, to put the Cuban economy as completely through the wringer as would have been required by a laissez-faire policy. The episode is another demonstration of how Cuba's choice of policy was influenced and limited by the absence of an independent monetary system and a central bank.

## CHAPTER VII

### EXCHANGE FLUCTUATIONS, 1938-1940

THE MECHANISM DESCRIBED in Chapter V maintained the peso at very close to parity from the early months of 1933 until the middle of 1938. There was a weak spell in the fall of 1934, and there were seasonal fluctuations in step with the rhythm of the sugar crop, but throughout these years the discount virtually never exceeded 2 per cent, and on average was considerably lower. Between April 1933 and June 1938, peso issues totaling 76 million were authorized, of which 49.3 million were actually disbursed.<sup>1</sup> The net expansion of Treasury credit money, equal to the seigniorage profit, amounted to 35.1 million.<sup>2</sup>

The relative stability of the peso, however, could deceive neither the business community nor the government as to the limits of the silver policy. Both sides knew that once the saturation point was reached, depreciation was imminent. Disagreement existed only as to the amount of pesos the market could absorb without becoming saturated. As early as September 1937 some bankers felt that the critical point was close at hand and that a small drop in the price of sugar might make even the existent peso supply abundant. Other bankers, however, regarded the situation somewhat more optimistically.

More optimistic than any was the government. In connection with the authorization, on June 23, 1938, of a new coinage of 20 million silver pesos, a spokesman declared that government experts had found, after a careful study, that the market was

<sup>1</sup> The remainder was issued after June 1938.

<sup>2</sup> The silver purchases were financed, in most instances, with Export-Import Bank credits. The repayment of these credits caused an equivalent contraction in the dollar circulation, leaving a net expansion equal to the seigniorage profit.

in a position to digest the issue.<sup>3</sup> No indication was given as to how this result was arrived at. It may be assumed, however, that the government relied heavily upon the Treasury's monetary statistics, which seemed to show that, as of June 30, 1938, the volume of dollar currency in circulation amounted to 41.3 million. Presumably it was felt that this amount provided a sufficient cushion for a 20-million-peso issue, but unfortunately the Treasury's figures were grossly misleading, and reliance upon them was bound to prove disappointing.

### I. SATURATION OF THE PESO CIRCULATION

In any case the volume of dollars still in the hands of the public was no safe indication of the amount by which the peso circulation fell short of covering monetary requirements, because part of the dollars still left in Cuba probably were hoarded and hence no longer played an active role in the internal circulation.<sup>4</sup>

A better index of the relative redundancy of peso currency was the volume of pesos in the banks. Since unneeded currency tended to be deposited in banks and, in the absence of a central bank, to accumulate there, the growth in the banks' holdings is a reflection of an excess in the circulation. Owing to the pronounced seasonality of the banks' currency holdings, comparisons can be made only between identical months of successive years. Between January 1937 and January 1938 the volume of peso reserves in the banks remained almost constant; it amounted to 21.5 million for the earlier and 22.1 million for the later year. From July 1937 to July 1938, however, holdings rose from 14.9 million to 23.5 million, or 58 per cent, while peso

<sup>3</sup> Commerce, *Latin American Financial Notes*, No. 245, June 14, 1938, p. 8.

<sup>4</sup> The continued functioning of the dollar as a part of the active internal circulation did not necessarily require dollars actually to pass from hand to hand in commercial transactions. It merely implied that firms and individuals held dollars as part of their working balances because the volume of pesos was insufficient to provide the public with the balances they considered necessary. The presence of a peso discount would naturally cause dollars to be used as sparingly as possible. Hence, the actual frequency with which dollars appeared in internal market transactions is no sure indication of the dollar's real monetary significance. This must be borne in mind in evaluating contemporary accounts of the extent to which the dollar was used in circulation.

TABLE 7  
 PESO-DOLLAR RATE, 1932-1945

|           | 1932   | 1933   | 1934   | 1935   | 1936   | 1937   | 1938   | 1939                |
|-----------|--------|--------|--------|--------|--------|--------|--------|---------------------|
| January   | 0.9975 | 0.9837 | 0.9850 | 0.9806 | 0.9912 | 0.9869 | 0.9950 | 0.9756              |
| February  | 0.9975 | 0.9875 | 0.9900 | 0.9906 | 0.9925 | 0.9925 | 0.9950 | 0.9752              |
| March     | 0.9925 | 0.9900 | 0.9962 | 0.9975 | 0.9937 | 0.9944 | 0.9950 | 0.9634              |
| April     | ...    | 0.9925 | 0.9975 | 0.9969 | 0.9875 | 0.9875 | 0.9937 | 0.9637              |
| May       | ...    | 0.9887 | 0.9991 | 0.9919 | 0.9900 | 0.9869 | 0.9812 | 0.9512              |
| June      | ...    | 0.9750 | 0.9962 | 0.9919 | 0.9881 | 0.9887 | 0.9744 | 0.9375              |
| July      | 0.9800 | 0.9787 | 0.9900 | 0.9912 | 0.9862 | 0.9887 | 0.9762 | 0.9086 <sup>b</sup> |
| August    | 0.9600 | 0.9850 | 0.9912 | 0.9919 | 0.9825 | 0.9900 | 0.9742 | 0.8852              |
| September | 0.9500 | 0.9875 | 0.9875 | 0.9819 | 0.9806 | 0.9925 | 0.9675 | 0.9087              |
| October   | ...    | 0.9888 | 0.9850 | 0.9812 | 0.9812 | 0.9937 | 0.9664 | 0.9055              |
| November  | 0.9887 | 0.9862 | 0.9737 | 0.9825 | 0.9862 | 0.9937 | 0.9717 | 0.8716              |
| December  | 0.9875 | 0.9825 | 0.9850 | 0.9906 | 0.9900 | 0.9925 | 0.9805 | 0.8874              |

TABLE 7 (Continued)

|           | 1940   | 1941   | 1942   | 1943   | 1944   | 1945   | 1946   | 1947   |
|-----------|--------|--------|--------|--------|--------|--------|--------|--------|
| January   | 0.8980 | 0.9164 | 1.0001 | 1.0000 | 1.0420 | 1.0007 | 1.0000 | 1.0000 |
| February  | 0.9184 | 0.9284 | 1.3406 | 1.0000 | 1.0300 | 1.0005 | 1.0000 | 1.0000 |
| March     | 0.8953 | 0.9441 | 1.1250 | 1.0000 | 1.0020 | 1.0000 | 1.0000 | 1.0000 |
| April     | 0.8827 | 0.9553 | 1.1718 | 1.0028 | 1.0017 | 1.0000 | 1.0000 | 1.0000 |
| May       | 0.8975 | 0.9737 | 1.1562 | 1.0038 | 1.0019 | 1.0000 | 1.0000 | 1.0000 |
| June      | 0.8980 | 0.9866 | 1.0006 | 1.0084 | 1.0019 | 1.0000 | 1.0000 | 1.0000 |
| July      | 0.9003 | 0.9870 | 1.1000 | 1.0168 | 1.0013 | 1.0000 | 1.0000 | 1.0000 |
| August    | 0.8853 | 0.9889 | 1.1000 | 1.0020 | 1.0000 | 1.0000 | 1.0000 | 1.0000 |
| September | 0.9012 | 0.9950 | 1.0002 | 1.0033 | 1.0000 | 1.0000 | 1.0000 | 1.0000 |
| October   | 0.9131 | 0.9981 | 1.0000 | 1.0600 | 1.0000 | 1.0000 | 1.0000 | 1.0000 |
| November  | 0.9133 | 0.9986 | 1.0000 | 1.0650 | 1.0000 | 1.0000 | 1.0000 | 1.0000 |
| December  | 0.9134 | 0.9994 | 1.0000 | 1.0400 | 1.0000 | 1.0000 | 1.0000 | 1.0000 |

\* No quotation available.

b On July 5, 1939 a nominal minimum of 0.8200 was reached

Sources: January-September 1932, various newspaper items; November 1932-October 1934, National City Bank, November 1933-August 1936, published quotations of the Havana Stock Exchange, *Cuba Económica y Financiera*, August 1936, p. 17, September 1936-December 1939, Pérez and Pazos, *El Problema Monetario*, p. 171; January 1940-December 1945, *Cuba Económica y Financiera*, February 1943, p. 23, and following issues; January 1946-December 1947, Dirección General de Estadística, *Boletín Mensual de Estadísticas*, February and December 1947.

deposits, against which these funds were held as reserves, were up less than 10 per cent (see Table 14). From January 1938 to January 1939, the rise was even more pronounced; during this period reserves increased from 22.1 million to 34.1 million, or 54 per cent, while deposits gained only 21 per cent.<sup>5</sup>

The evidence seems to show that after January or, at the latest, April 1938 the market no longer was able to absorb fully the growing volume of currency put out by the government. This does not inevitably lead to the conclusion that the internal market had become saturated during the first half of 1938 and that none of the 14.2 million dollars in currency estimated to have been in the hands of the public at the end of 1937 remained in active circulation (see Table 6). Rather, one would expect the displacement of the dollar and the accumulation of pesos in banks to overlap to some extent. Nevertheless, it is probably correct to surmise that in the summer of 1938 only a small part of the 14.2 million dollars was still active and that most of these were in effect being hoarded. In other words, there is reason to think that the market's absorptive capacity for further currency issues at that time was a good deal less than the government professed to believe.

## 2. THE PESO DEPRECIATES

This situation explains the gradual decline in the peso that took place in 1938. During the crop season there was still considerable demand for pesos, but in the latter part of the year the situation deteriorated owing to the shrinkage in business activity on the one hand and the government's steady injections

<sup>5</sup> The evidence is distorted somewhat by the fact that in August 1938 the banks were ordered to keep 75 per cent of their legal reserves of 25 per cent in peso currency. (For a discussion of this measure, see p. 121.) If the order had forced the banks to purchase pesos on a major scale, the subsequent growth of their holdings might be regarded as having been due merely to the effects of the order. Actually, however, there is no evidence that large transactions became necessary. The increase in peso holdings up to and beyond the required level, which was reached in October 1938, seems to have proceeded smoothly and more or less in line with the trend initiated earlier in the year. This increase therefore may be assumed to have been the result more of market factors than of a forced reorientation in reserve policy.

of new currency on the other.<sup>6</sup> From a rate of 99.375<sup>7</sup> in April, which compared favorably with that prevailing a year earlier, the peso dropped to 96.64 in October, almost 3 per cent below the rate of October 1937. During November and December there was a partial recovery, occasioned probably by advance purchases of peso currency in preparation for the coming crop. Beginning in January 1939, however, the decline was resumed. At first it continued slowly, but from the middle of May on it gathered momentum, until on July 5, 1939 an all-time low of 82.00 was reached.<sup>8</sup> Thereafter, apart from a few major advances and declines, the peso fluctuated fairly steadily around a rate of 90.00 until August 1940.

If there was anything surprising about this decline, it was not the magnitude of the drop, but the fact that it went no further. Between April 1938 and August 1939 the government added 23.7 million pesos to the peso supply in the hands of the public, involving a net addition to the money supply of about 15 million, and a more severe decline in the exchange rate might well have been expected. That it did not occur may be attributed to two factors. One of these was that even before the onset of depreciation the public, insofar as it was exchange-conscious, had apparently restricted its peso holdings persistently to so low a level, in relation to working requirements, that a further reduction was impracticable. In that case a very substantial flight from the peso could not take place. The second factor was the effect of various measures which the government took to counteract depreciation.

### 3. GOVERNMENT COUNTERMEASURES

For the next two or three years the government struggled valiantly, though most of the time vainly, against a depreciation

<sup>6</sup> Until July 1938, the new currency seems to have been derived from the 20 million peso issue authorized in June 1936. Thereafter it came from the June 1938 issue, which was not completely disposed of until the second half of 1939.

<sup>7</sup> In view of the wider fluctuations that occurred in 1938 and after, it is preferable to change our terminology and to quote the peso in terms of per cent of parity, instead of speaking of its discount from parity as heretofore.

<sup>8</sup> This quotation, given by Pérez and Pazos, was nominal. The average rate for the day was 86.883, which was a little above the rates touched on a few days of the following November (*El Problema Monetario*, p. 73).



largely of its own making. For this struggle it could hardly have been more poorly equipped. Owing to budgetary difficulties, it could or would not reduce the excessive volume of currency, and it was only when the peso had dropped by over 10 per cent that expansion was brought to a halt. Lacking any of the customary instruments of monetary control, such as a central bank or a stabilization fund with adequate reserves, it had to resort to a series of improvisations, some of them of dubious merit and little effectiveness. A few of these measures embodied, in a rudimentary manner, some of the familiar devices of monetary policy, such as shifts in Treasury funds and changes in reserve requirements. The scope, however, on which they could be carried out, was inadequate. Altogether the government took five major steps in its effort to support the peso: (a) a decree requiring equal treatment of dollar and peso deposits; (b) fixing of peso reserve requirements; (c) the deposit of official funds in the Treasury; (d) the creation of a stabilization fund; (e) a law authorizing payment in pesos of certain dollar obligations (legal tender law).

#### A. EQUAL TREATMENT OF DOLLAR AND PESO DEPOSITS

A decree of July 12, 1938, required all banks carrying demand or savings deposits in dollars to give equal treatment to peso accounts, to pay the same rates of interest on such deposits, and in general to provide "the same privileges, advantages, and facilities" enjoyed by dollar accounts.<sup>9</sup> Each bank was to report daily its deposits and cash position to the Treasury.

This decree might have been quite effective in giving a wider range of functions to the peso and thus in raising the demand for it, if the banks had really been discriminating against peso accounts. Actually, however, the practices that the decree sought to impose had been observed for several years by all banks but one, which thereupon amended its policy.<sup>10</sup> The main obstacle to the more rapid growth of peso savings deposits was not so much an adverse attitude of the banks, as

<sup>9</sup> Decree 1418, *Gaceta Oficial*, July 14, 1938.

<sup>10</sup> Current accounts in pesos had been opened by all banks as early as 1932, when the discount first made itself felt. Savings deposits in pesos were first accepted in 1936.

the public's lack of confidence in the peso. It is true that peso savings deposits did show a fairly substantial growth during the next few years. This, however, probably was attributable chiefly to the fact that from 1939 to 1941 the average Cuban did not often see a dollar bill, and to the fear that dollar deposits might be made repayable in pesos, which was stimulated by the legal tender law of 1939 (see below).<sup>11</sup> The effectiveness of the measure must be regarded as minor.

#### B. FIXING OF PESO RESERVE REQUIREMENTS

On June 28, 1938 the government issued a decree reminding the banks of the long-forgotten 25 per cent reserve requirements of the Commercial Code.<sup>12</sup> The decree authorized the Secretary of the Treasury to decide what part of the legal 25 per cent reserve should be maintained in pesos. On August 2, 1938, the Secretary fixed this proportion at 75 per cent.<sup>13</sup>

When the decree was issued, the reserves of the banks as a group happened to be close to a reserve ratio of 25 per cent for the first time in many years, and the requirements of the Commercial Code were thus in fact being met by a number of banks, if not by all (see Table 14). Peso reserves alone, however, were less than 25 per cent of the total, falling short of the required amount by 3.2 million.<sup>14</sup> The purpose of the order was to force the banks into the market in order to cover this deficiency.

The order caused much bitter feeling between the government and the banks. The Secretary of the Treasury was reported to hold the view that the banks were responsible for the peso discount. The banks believed that the fixing of high peso-reserve requirements was intended as a retaliatory measure. They argued that instead of reducing the discount, the effect of the

<sup>11</sup> The development of savings deposits in Cuban banks was as follows (in millions):

|      | <i>Pesos</i> | <i>Dollars</i> |
|------|--------------|----------------|
| 1938 | 6.4          | 44.8           |
| 1939 | 9.0          | 41.5           |
| 1940 | 13.7         | 27.1           |

<sup>12</sup> Decree 1327, quoted in *Federal Reserve Bulletin*, September 1938, p. 768.

<sup>13</sup> *Ibid.*

<sup>14</sup> As of July 31, 1938, three days before the Secretary's order.

order would be to curtail credit and hamper the financing of the coming crop.

Basically the dispute hinged on a matter of banking policy. The banks maintained that sound policy required them to balance assets and liabilities in each currency, so as to remain immune to currency fluctuations. The evidence available to the Secretary showed, however, that while in general the banks maintained a balanced position from year to year, some of them, if not all, did take seasonal positions. The usual practice was to let peso assets decline relative to liabilities during the first half of each year, when the peso was strong owing to crop-financing needs, and build up a long position during the off-season, when pesos could be purchased cheaply. This was not only profitable, but also in keeping with the needs of the market, and tended to even out the fluctuations of the peso through the year.

In order to comply with the Secretary's order, two roads were open to the banks. One was to increase their peso holdings by selling dollars against pesos, which was what the Secretary wanted and expected them to do. This, however, would have forced them to alter their position, and perhaps to go long of pesos.<sup>15</sup> Alternatively, they could maintain whatever exchange position they thought desirable, and meet the requirements of the order by reducing peso loans and investments, in that manner increasing their peso cash and reducing their deposits. The first procedure would cause an immediate demand for pesos against dollars and thus an improvement in the peso rate. The second procedure also would tend to strengthen the peso, but not to the same degree, and at a greater cost to the Cuban economy. For, while such credit contraction would reduce the supply of pesos and ultimately perhaps improve the balance of payments, it would also react unfavorably upon the volume of business and upon the demand for pesos in the internal market. The net result therefore would probably be a less pronounced gain for the peso than in the first case.

<sup>15</sup> The banks' peso position in July 1938 cannot be determined with exactness, but the data warrant the presumption that there was no substantial short position at that time. See Table 12.

The rapidity with which the government pushed additional currency into circulation allowed most of the banks to avoid a decision in favor of one or the other policy, although some of them no doubt were more strongly affected by the new reserve requirements than others. The monthly data on exchange operations (Table 12) show that there was no increase in peso purchases, nor was there any significant decline in loans. Instead, the banks relied upon deposits of newly issued currency to bring their reserves to the required level, which was reached by the middle of October. The peso meanwhile continued to decline at a slow but steady pace. The net effect of the new reserve requirements, therefore, in contrast to the controversy they had excited, turned out to be minor.<sup>16</sup>

#### C. DEPOSIT OF OFFICIAL FUNDS IN THE TREASURY

The government's monetary worries were allayed temporarily by the mild recovery of the exchange rate that occurred in November and December, lifting the peso from a rate of 96.64 to 98.05. The improvement, however, was deceptive, for in spite of the oncoming crop season the peso resumed its downward course in January. Weakness during the harvest period was a new phenomenon and one which did not bode well for the future. Following a cabinet announcement on March 10, promising early action against "speculation in Cuban currency," a decree of March 29, 1939, ordered all "official accounts" to be transferred from the banks to the Treasury.<sup>17</sup> These accounts consisted of funds derived from the budget, or which had otherwise been collected by the government or under its authority. Their aggregate was roughly equal to the as yet unissued portion of the latest 20-million-peso coinage, in the neighborhood of 4 to 6 million, and their withdrawal from the market, according to the decree, was to counteract whatever effect the subsequent expenditure of the remainder of the issue might have.

<sup>16</sup> It might be objected that in the absence of reserve requirements the banks might have sold pesos and that the rise in the discount would have been correspondingly faster. Sales of pesos during the second half of the year were not in conformity with the banks' usual practice, however, which called for the building up of a long position during the peso's seasonal period of weakness.

<sup>17</sup> Decree 590, *Gaceta Oficial*, March 22, 1939.

The Treasury was to render the same services for the departments and agencies whose accounts were being transferred as had previously been performed by the banks.

During April and part of May 1939 the peso remained relatively firm. This may to some extent be attributed to the withdrawals of government funds from the banks. Their effect, however, failed to be reflected in monetary and banking statistics, partly because of simultaneous injections of new currency by the government, and also because it was largely eclipsed by the seasonal movement of reserves, loans, deposits, and exchange transactions. The banks in the aggregate continued to be net sellers of pesos, although at a much slower rate than during the first three months of the year; their loans and deposits went up under the influence of crop demands and their reserves went down, as in previous years. Toward the end of May the effect of the official transfers, which by that time amounted to over 2.5 million pesos,<sup>18</sup> had evidently worn off, and the peso resumed its downward trend at an accelerated pace. The idea underlying the measure had been sound, and the transfers served, no doubt, to counteract to some extent the effect of simultaneous new injections. The government's resources were insufficient, however, to carry out an operation of the scope required to bring about a net reduction in bank reserves and thereby lend support to the peso.

#### D. CREATION OF A STABILIZATION FUND

On April 8, 1939, even before the transfer of official balances had been completed, the President asked the legislature for authority to take whatever measures might be required to check the decline of the peso.<sup>19</sup> The request was founded upon the assertion that the discount was due not to fundamental economic disturbances but to "speculation," and that this situation should not be permitted to continue. Owing perhaps to the relative stability of the exchange during the following weeks, the Congress took no action. When a renewed drop occurred in the latter part of May, however, the President on his own

<sup>18</sup> Commerce, *Latin American Financial Notes*, I (June 14, 1939), 1737.

<sup>19</sup> *Gaceta Oficial*, April 8, 1939.

initiative, issued a decree creating the National Currency Stabilization Fund.<sup>20</sup> The main feature of this measure was a clause requiring exporters of sugar to surrender in dollars 20 per cent of their proceeds to the Treasury, against payment in Cuban pesos at par. Other exporters were required to surrender 10 per cent.<sup>21</sup> The Treasury was to use these dollars to service the foreign debt. Whatever was left over was to be employed as a fund for the regulation of foreign exchange.

The measure plainly had more to do with exchange control than with stabilization. It had the effect of levying a tax upon exporters, for the latter were deprived of 10 or 20 per cent, respectively, of the premium on their dollar sales. For the government the cost of financing the debt service was correspondingly reduced.

It was made explicit that this reduction in the cost of the debt service was the authorities' main consideration, but they also professed to believe that the measure would cause the peso to return to par.<sup>22</sup> Unfortunately, nothing of the kind happened. Since the Stabilization Fund lacked exchange reserves, it could put no more exchange into the market than it had previously taken out. The net supply and demand situation remained unaffected, for if exporters had not received pesos from the government, they would have had to purchase them in the market.<sup>23</sup> Virtually the sole influence, therefore, which

<sup>20</sup> Decree 1358, June 10, 1939, *Gaceta Oficial*, June 15.

<sup>21</sup> The Secretary of the Treasury was to fix the date on which deliveries of dollars were to begin. The 10 per cent due on exports other than sugar never was called up.

<sup>22</sup> In the preamble to the decree, it was argued that the partial surrender of export proceeds would not create a special burden for exporters, because the exchange of a certain amount of dollars at par probably would cause parity to be reestablished in all exchange operations. Moreover, in case this hope should be disappointed, exporters would be compensated for the loss of part of the dollar premium by the "notable improvement in the conditions of the exchange market." The first of these arguments, although too optimistic, is at least consistent, but the second is hardly convincing.

<sup>23</sup> A very minor improvement in the demand for pesos may have taken place, which, however, has hardly more than theoretical interest. Sugar exporters required a given amount of pesos for making the crop, which they obtained by selling dollars. The greater the discount, the less the amount of dollars needed to obtain the necessary pesos. By requiring exporters to exchange 20 per cent of their dollars at par, the government forced them to spend a few more dollars to

the Fund could exert on the market, was through the timing of its purchases and sales, that is, through the seasonal redistribution of the dollar supply.

Limited though these activities would have been, they might have presented very interesting possibilities if circumstances had allowed the Fund to develop a regular operating policy. The seasonal rhythm to be corrected was characterized, as mentioned before, by a weak spell during the summer, when sugar producers ordinarily were not interested in buying pesos, followed by a gradual rise toward the end of the year, and culminating in pronounced firmness during the first two or three months of the new year. By selling dollars during the summer the Fund would have been in a position to cushion the seasonal decline.

Because of the limited scale of its operations, the Fund, to be sure, could not have achieved a perfect balance of supply and demand in the exchange market during the year. It might, however, have been fairly successful in controlling the sinking spell during the summer. An essential condition of effective operation was, of course, that exporters kept the pesos they were forced to acquire during the summer. If they preferred to pay the cost of a "round trip" from pesos into dollars and later back into pesos, instead of holding pesos during the dead season, the selling pressure during the summer would be intensified. All the Fund could have done in that case was to sell its available exchange and thereby reestablish the demand-supply situation that would have prevailed if it had not functioned at all. A net effect upon the market would have been impossible.

The possibility of successfully conducting these operations was never put to a test. In the first place, the authorities for several months were unable to develop a satisfactory technique for disposing of the Fund's dollars. Operations, in the second place, were hampered by the fact that the Fund not only lacked dollars, but was likewise devoid of adequate peso reserves. This prevented it from accumulating dollar balances in excess of what the Treasury could spare from its working balances,

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obtain a given amount of pesos than would otherwise have been necessary. With a discount of 10 per cent, the extra amount of dollars to be spent was 2 per cent of total dollar proceeds.

which was not very much. Finally, such influence as the Fund might have had was largely obliterated by the outbreak of the war.

The decree establishing the Stabilization Fund said nothing about the manner in which surplus dollars were to be used in regulating the exchange market. There ensued, therefore, a period of experimentation and abrupt policy changes. The Fund began to make informal sales to the market some time in September,<sup>24</sup> but these operations immediately gave rise to charges that favoritism was being shown to certain interests. Sales were then suspended, and an auction was arranged, which took place on October 31.<sup>25</sup> This measure insured impartiality, but was otherwise not a happy one. The government received bids for a total of 2.9 million dollars and sold 700,000. The effect on the exchange rate was entirely negative, for the peso declined from 90.54, where it had stood six days before, to 89.403 on the day of the auction and to 88.312 six days thereafter.

After this minor fiasco the auction method was abandoned, and for a while the Fund resumed its sales in the open market. During November over one million dollars were disposed of in this manner, with an apparently beneficial effect on the exchange rate. A different system was announced on December 19 which involved the allocation of exchange at par to various groups of importers.<sup>26</sup> First call on the Fund's surplus dollars<sup>27</sup> was given to local newspapers — previously vigorous critics of the Fund's methods — which were to receive dollars for a third of their newsprint imports. Funds left over after this allocation were to be prorated among importers of primary necessities. A list of the favored articles was included in the decree. United States products were to receive preference,<sup>28</sup>

<sup>24</sup> Commerce, *Latin American Financial Notes*, I (November 14, 1939), 373.

<sup>25</sup> Resolution of the Secretary of the Treasury, October 24, 1939, *Gaceta Oficial*, October 27.

<sup>26</sup> Treasury Resolution of December 19, 1939.

<sup>27</sup> The amount remaining after requirements for the government's foreign debt, the diplomatic service, and governmental purchases had been met.

<sup>28</sup> Probably in order to avoid a conflict with the anti-exchange control provisions of the Reciprocity Treaty.



and next in line were countries with which Cuba had a favorable trade balance.

This arrangement deprived the Fund's operations of all flexibility. Its functions now consisted in levying a tax upon exporters<sup>29</sup> and in subsidizing the government, the newspapers, and certain importers. Since the amounts available for allocation for essential imports were quite small, a significant influence on the cost of living could not be expected. Although the operations of the Fund still were capable of producing a seasonal redistribution of the dollar supply, the direction of the change was entirely a matter of chance, since collections and sales were now purely mechanical.

On May 3, 1940 the Secretary of the Treasury announced that surplus dollars would again be sold in the market, and that the profits would be employed for the purchase of gold bars to strengthen the backing of the silver certificates.<sup>30</sup> Presumably the plan would have involved the retention of dollars equivalent to the profits realized by the Fund, and their subsequent conversion into gold. How this gold was to be employed as a guarantee for the silver certificates was not made clear. Some 1.2 million pesos of certificates had previously been issued against gold which had gradually accumulated in the Treasury (see Table 5), but these, like all other certificates, were convertible into silver and not into gold. Probably the intention was to accumulate a monetary reserve, to be employed if and when a central bank or similar agency capable of using it was established. As a manifestation of good intentions this foresight was entirely praiseworthy, but its timing was questionable. In view of the continuous weakness of the peso it would have been better to employ every dollar to strengthen the market, instead of accumulating funds for future emergencies.

Paradoxically enough, the announcement had a favorable influence upon the peso. The fact that dollars were to be di-

<sup>29</sup> The percentage of proceeds to be delivered by sugar exporters had been raised from 20 to 30 per cent, by Decree 2222, *Gaceta Oficial*, September 13, 1939. The same decree raised the percentage for other exports from 10 to 15 per cent, but the delivery of this amount remained in suspense.

<sup>30</sup> Commerce, *Latin American Financial Notes*, II (May 29, 1940).

verted from the exchange market did not impress the market so much as the demonstration of conservative principles implicit in the gold-purchase program. The peso firmed slightly, but weakened again when the abandonment of the program was announced two weeks later. The reversal was explained on the grounds that Cuba lacked legislation for the purchase of gold as well as for its use as a currency reserve. It was decided instead to accumulate the profits of the Fund for use in future operations. At the same time it was announced that dollar sales at par to private interests would be discontinued, and that dollars would be sold through the banks at the prevailing rate.<sup>31</sup>

The new program was modified again by a decree of July 12,<sup>32</sup> which stated that part of the Fund's profits would be withdrawn from circulation, in order to reduce the volume of pesos outstanding. A sum of 250,000 pesos monthly was to be set aside in this manner, and no disbursements were to be made without the consent of the cabinet. This measure was an effective one, at least in principle. Consistently carried out over a period of time, it would have reduced the supply of currency and thus, *ceteris paribus*, would have brought about a rise in the peso. Unfortunately, however, the profits of the Fund were not large enough to make withdrawals effective in the short run.<sup>33</sup> Toward the end of 1940, the Fund's total dollar receipts became so small that they even failed to cover the government's own exchange requirements. Sales to the market had to be abandoned temporarily. During 1941 the volume of sugar exports and hence the receipts of the Fund

<sup>31</sup> The newspapers apparently had been the sole beneficiaries of dollar sales at par, after the distribution to importers of primary necessities had been discontinued.

<sup>32</sup> *Ibid.*, August 14, 1940, p. 288.

<sup>33</sup> The Treasury made public the following report (*La Prensa* [New York], September 6, 1940) on the operations of the fund, up to August 10, 1940 (in pesos):

|                           | <i>Sales</i>     | <i>Profits</i>  |
|---------------------------|------------------|-----------------|
| July 25-December 22, 1939 | 5,710,000        | 682,800         |
| March 28, 1940            | 1,000,000        | 133,800         |
| May 13-August 10, 1940    | 4,133,000        | 448,600         |
|                           | <hr/> 10,843,000 | <hr/> 1,265,200 |

increased once more, a development which was accompanied by a pronounced revival in business and a sharply favorable turn in the balance of payment. During this period the Fund was able to engage in substantial operations. Their effect, however, was dwarfed completely by the wave of activity that engulfed Cuba and swept the exchange rate back to and even above par within a year. After the end of 1940, therefore, the Fund lost most of its significance.

#### E. PESO PAYMENT OF CERTAIN DOLLAR OBLIGATIONS

On June 29, shortly after the creation of the Stabilization Fund, the President sent a message to the legislature requesting authority to increase the silver circulation by 15 million pesos for budgetary purposes. He could not have found a more effective means of frustrating all efforts to maintain exchange stability. Although in the light of past budgetary practices the message did not come as a complete surprise, the reaction of the market was most unfavorable. In the week following the announcement, the peso declined sharply, and on July 5 a minor panic developed, during which nominal rates were quoted as low as 82.00, although no transactions appear to have taken place below 84.00. In the face of this break a hurriedly summoned cabinet meeting decided to abandon the proposed issue and to take further steps for the protection of the peso.

The announcement that the coinage plans had been discarded brought the panic to an immediate end. The peso rallied quickly and for a short while even returned to the level it had occupied prior to the incident. The improvement was short-lived, however, and a few days later the rate again had fallen below 90.00, the level around which it was to fluctuate for the next year.

The protective measures agreed upon at the cabinet meeting of July 5 centered in a new legal tender law which became effective on July 10.<sup>34</sup> This law invalidated the distinction between pesos and dollars in the discharge of most domestic obligations and made pesos legal tender for the discharge of new as well as old dollar contracts, with a corresponding loss

<sup>34</sup> *Gaceta Oficial*, July 10, 1939.

to the creditor in the case of old contracts.<sup>35</sup> It did not, however, apply to operations in connection with exports, to deposit liabilities of banks, and to the service of the government's dollar bonds. At the request of the clearing house banks, the law was clarified by a subsequent decree<sup>36</sup> which reiterated that the law covered only internal operations and was not meant to apply to international transactions. The following operations, in addition to the three classes mentioned above, were listed as being unaffected: (1) operations originating from imports; (2) credit transactions in connection with imports; (3) exchange operations and remittances abroad; (4) loans secured with stocks and bonds in foreign currencies; (5) loans on produce to be exported; (6) overdrafts.<sup>37</sup>

The legal tender law of July 8 amounted to a revival of some of the radical and short-lived features of the 1934 monetary legislation. By constituting the peso legal tender for dollar contracts, it made every creditor dependent upon the good will of his debtor, who was free to avail himself of the opportunity to repay at a discount if he so desired. Nevertheless, it was not nearly so far-reaching as the earlier legislation would have been, had the latter remained in force. In the first place, it was more narrowly circumscribed and left untouched the international sector of the economy, where dollar contracts were of particular importance. In the second place, the range of transactions carried out in pesos had widened greatly since 1934, as shown by the fact that while peso clearings in 1934 amounted to only

<sup>35</sup> These provisions took the form of an amendment to Law 410 of August 10, 1934, in which the surviving features of the monetary legislation of 1934 had been consolidated. The law of July 8, 1939, further provided for the punishment of speculation and for the supervision, if necessary, of exchange transactions, and authorized the President to take measures to safeguard the currency and to prevent price increases. These potentially far-reaching provisions, however, had only minor repercussions. Prior to the publication of the law, the President had signed a decree prohibiting the increase of food prices above those of July 1, and several prominent merchants were arrested when they undertook to adjust their selling prices to the exchange rates prevailing at the height of the panic.

<sup>36</sup> Decree 1727, July 19, 1939.

<sup>37</sup> Payments to steamship companies were added to this list by Decree 820 of March 30, 1940 (Commerce, *Latin American Financial Notes*, II [May 14, 1940], 169).

46.5 per cent of the total, they had risen to 63.3 per cent in 1938. In the third place, many of the dollar obligations that became payable in pesos were frozen under the moratorium, and no payments of principal were being made for the time being in either currency. Finally, and this was perhaps the most important factor, many dollar debtors refused to avail themselves of their rights under the law, in order to preserve their credit standing. Knowing this, the banks continued to make dollar loans to customers who enjoyed their confidence. For all these reasons, the measure, in spite of its apparently incisive nature, did not have very pronounced effects. The ratio of peso and dollar clearings did not change noticeably, there was no material decline in dollar loans, at least for the time being, and the peso rate, the center of all this legislative attention, did not improve.

The only marked development was a sudden reduction in the volume of dollar deposits. During July alone the banks lost 7.2 million dollars in demand deposits and 5.7 million in savings deposits, totaling 16.9 per cent of their aggregate dollar deposits. To meet these withdrawals they drew on their dollar balances abroad and went into the red with their head offices or correspondents. At the end of 1939 the banks showed net liabilities abroad of 7.8 million dollars, compared with net assets of 5.2 million at the beginning of the year.<sup>38</sup> The decline in dollar deposits in Cuba was due primarily to the flight of capital from the island, rather than to mere withdrawals of dollar bills into hoards. If the latter had been the case, the banks would have had to import dollar currency, whereas in fact there was a net currency outflow. Capital flight probably was motivated primarily by the fear that exchange control might be reintroduced. A second factor was the belief, fostered by recurrent rumors, that dollar deposits might become repayable in pesos. Apprehension in this respect was responsible particularly for the reduction in dollar savings deposits. The movement in bank deposits during July 1939 tends to confirm

<sup>38</sup> The existence of a net debit balance with foreign correspondents for the system as a whole does not preclude, of course, the possibility that some individual banks may have preserved a credit balance.

the belief expressed in an earlier chapter that a broadening of the legal tender status of the peso and a correlative weakening of the status of the dollar would lead to flight of capital, and would deprive Cuba of part of her foreign exchange resources.

It is evident that the legal tender law brought about a considerable shift in the Cuban money supply in favor of the peso, as a result chiefly of the drop in the volume of dollars. If this shift had been accomplished by an increase in the use of the peso in current transactions, the law might have succeeded in bringing about a noticeable improvement in the exchange rate. The clearing figures show, however, that the relation of peso and dollar transactions did not change substantially. All that took place immediately was an increase in the velocity of turnover of dollar deposits, and a slowing down in that of peso deposits. A significant improvement in the exchange rate, therefore, was not to be expected and did not occur, although the law probably helped to stem a further drop in the rate.

## CHAPTER VIII

### APPRAISAL OF THE SILVER POLICY

AFTER THE ABORTIVE ATTEMPT in June 1939 to continue the policy of silver issues, which produced a mild panic, no further issues were undertaken. The abandonment of the silver policy brought to an end an important episode in Cuba's monetary history, and it is worthwhile to assess the results. It is perhaps not unfair to say that the "silver policy" described in the preceding chapters was not so much a policy as an improvisation. It profoundly transformed the Cuban monetary system, but it is obvious that its sponsors had little conception of what the final result would be. When legislation was passed in 1934 which in effect cut Cuba loose from the dollar, it appeared that a well-defined course had been charted, leading to the proximate establishment of a central bank and of an autonomous currency. The salient features of this legislation were abandoned very soon, however, and the situation thereafter was again permitted to drift.

It was frequently predicted during the thirties that Cuba was moving toward a silver standard. This expectation was not unreasonable, for continued peso issues ultimately were bound to cause a depreciation of the currency to the level of its bullion value. Others, even more pessimistic, suggested that eventually the silver certificates would be made inconvertible, and that the peso would then drop below its silver value. All these predictions, however, proved false. The peso always held far above its bullion value, and remained a "note printed on silver," as Graham had called it in 1934.<sup>1</sup> In 1939, when the sudden break in the peso made it necessary to choose between further money creation and exchange stability, the government did not hesitate to decide in favor of the latter. The determi-

<sup>1</sup> Foreign Policy Association, *Problems of the New Cuba*, p. 328.

nation to maintain stability which was manifested on this occasion appears to have been the sole clearly defined feature of the monetary policy of the thirties.

In business circles, and particularly among bankers, the silver policy has found few defenders. Among economists it has received a varied but on the whole not entirely unfavorable reception. Graham suggested that the issues completed up to the time of his writing<sup>2</sup> had done some good and no harm, but warned against their continuation.<sup>3</sup> Llitas expressed the opinion that the government's method of successive coinages was perhaps the safest and most practical way of accustoming the public to a new type of money and that another, more "scientific" method might have had unfavorable repercussions.<sup>4</sup> Pérez and Pazos finally pointed out that the seigniorage profits connected with the replacement of an expensive by a cheaper currency had been a significant gain. They added, however, that by creating a central bank the government could have achieved the same gains without disorganizing the monetary system. They also criticized the employment of seigniorage profits for budgetary needs, instead of for permanently productive purposes.<sup>5</sup>

Looking at the silver policy at a distance of several years, and in the light of some of the observations made in preceding chapters, one may say that, while poorly conceived and awkwardly executed, it was on the whole fortunate in its results. Certain of its effects were distinctly unfavorable, to be sure, but at the present time most of them seem to weigh less heavily than they did in the eyes of contemporary observers.

The most obvious of the unfavorable aspects was the creation of a dual currency system, with all its inconveniences. The silver peso, which began its career as a subsidiary currency, could not stand up to the dollar even after it had become unlimited legal tender. It bore the stigma of an inferior currency

<sup>2</sup> About 196 million pesos, excluding the issues before 1932.

<sup>3</sup> Foreign Policy Association, *Problems of the New Cuba*, p. 317.

<sup>4</sup> Juan A. Llitas, "Nuestra Anarquía Monetaria," *Isla* (Havana), No. 11, October 10, 1936, p. 13.

<sup>5</sup> Pérez and Pazos, *El Problema Monetario*, pp. 40-41.



and remained at a slightly fluctuating discount. This situation had various adverse repercussions. The fluctuations were a source of minor losses to the public, and a drag upon business. The uncertain future of the currency discouraged investment, particularly on the part of foreigners. The tendency of wealthy Cubans to export capital was intensified. The banks for the first time had to cope with an exchange problem, and their lending policy became even more cautious than before. The originally high elasticity of the Cuban monetary system was progressively reduced. Eventually, when an overissue of currency coincided with a business slump, the peso depreciated and the government found itself without adequate technical means of controlling the situation.

Unfortunate as these repercussions were, they need not be taken too tragically. Cuba's difficulties during the thirties, economic as well as political, were so severe that a significant expansion of investment or bank credit could not have been expected in any case. On this score, therefore, the island did not lose a great deal. The depreciation of 1939-40 was prevented from becoming acute by the government's firmness, and was eventually made to disappear by forces beyond governmental control. No permanent damage resulted. All in all, therefore, the consequences of the dual currency were less grave than might have been feared.

Another unfavorable aspect of the silver policy was the failure to make more effective use of the seigniorage profits yielded by the peso issues. Instead of being invested in a small, planned public works program, they were absorbed into the general budget, sometimes for expenditures of socially doubtful value. Expenditures were concentrated excessively in Havana, where most of the government offices are located, and too little money went into the provinces. A public works program might have permitted expenditures to be channeled toward those sections of the population that were most in need of assistance. The over-all volume of employment provided by a public works program, however, although socially more valuable, might not have been quite as large as that due to straight overspending,

because part of the funds would have gone for imported materials. This factor tended to limit the potential usefulness of public works expenditures.

What proportion of her dollar resources Cuba ought to have used up by replacing them with pesos is a different question. Modern thinking calls for the aggressive use of exchange reserves, as long as the passive balance is expected to be temporary. In Cuba's case it was clear that the deterioration in the island's position as a sugar exporter was not a transitory one. There was reason to think, however, that the situation would not remain quite as bad as it was during the years 1932-1934 or again in 1938-39. Probably it was not good policy to draw down exchange resources to the point where hardly any effective reserves were left, as was done in 1938. As a result the government was forced to curtail deficit spending (by means of silver issues) in 1939, when it was much more needed than during the immediately preceding years.<sup>6</sup> For the rapid recovery of dollar reserves after 1940 the government cannot claim credit. Nevertheless, it is interesting to observe that during 1941 and 1942 alone Cuba accumulated more dollars than she had lost during the entire decade of the thirties. This was a pure windfall, of course, and cannot be used as an argument to defend the policy of prematurely exhausting exchange reserves. But in the light of Cuba's wartime affluence, it is fortunate that reserves were spent relatively freely at a time when this could do some good.

A third aspect of the silver policy that calls for critical comment is the legacy of some sixty million ounces of coined silver, which it has bequeathed to the island. As a backing for the peso, the metal at present is worthless, unless the currency should depreciate to the level of its bullion value. The silver

<sup>6</sup> Although the money supply of international origin was much higher in 1938 than in 1932 — 65.7 million in the former as against 19.2 million in the latter year — Cuba's liquid international reserves were considerably lower in 1938. This is due to the fact that in 1932 Cuba had substantial *gross* international reserves which were liquid, although net reserves (and hence the money supply of international origin) were low, owing to the banks' heavy indebtedness to their head offices. In 1938, 32.4 million of Cuba's internal reserves were represented by the bullion cost of the silver coinage and hence were not liquid.

merely ties up exchange resources, which would be converted into usable reserves by melting down the coins and selling the bullion. Since the average cost of the silver, plus minting costs, was around 50 cents per ounce, the unrealized loss upon these holdings in 1939, when silver was selling at 35 cents per ounce, amounted to 9.4 million dollars. The wartime rise to 71.11 cents converted this into a paper profit of 13 million. If Cuba operates shrewdly, she may even be able to liquidate this unpromising investment with a handsome profit.

These faults of the silver policy, however, were outweighed by its virtues. Its great merit was that it allowed the government to mitigate somewhat the impact of the depression at a time when Cuba could secure credit neither at home nor abroad.<sup>7</sup> The relief which the government was able to give was not very large, but nevertheless of considerable importance. In some respects, it may have been the factor that kept the last straw off the camel's back and thus prevented its collapse.

The relief provided by the silver policy was both fiscal and monetary. In the fiscal sense, it permitted the financing of a deficit which otherwise would not have been possible. The total of these expenditures was only 48.6 million, equal to the seigniorage profits, and as said before, the money was perhaps not too well applied. Nevertheless, it amounted to 2 per cent of the estimated national income over the period (1932-1939) during which the expenditures took place.<sup>8</sup> Allowing for a multiplier of something less than two, the total effect from this angle alone, excluding monetary and acceleration effects, may have ranged between 3 and 4 per cent of national income.

From the monetary viewpoint, the silver policy involved an addition to the money supply equal to the 48.6 million seigniorage. The governmental deficit, in other words, was based on

<sup>7</sup> It is perhaps not quite accurate to say that Cuba was completely divorced from all sources of credit. The government could, and did, obtain credit by the simple device of not paying its employees and its bills. The floating debt, which in 1940 was estimated at 70 million pesos, had arisen almost entirely in this way. A drawback of this type of deficit spending, among others, was that it did not carry a very high multiplier, because the government's loans curtailed the purchasing power of the involuntary lenders.

<sup>8</sup> Based on the estimate by Julián Alienes, *The National Economy of Cuba* (Havana, 1942), p. 53.

pure money creation and did not absorb any existing savings. This money creation was particularly opportune in view of the sharp contraction carried on by the banks, mainly in connection with the collection of frozen loans inherited from the twenties. Aided by the increase in the money supply of international origin, the silver policy succeeded in lifting the volume of money above its 1934 low of 101.1 million to 143.4 in 1937, and maintaining it at approximately that level during the following depression, despite the ensuing unfavorable balance of payments (see Table 6).

It is not implied, of course, that the silver policy *caused* the money supply to be 48.6 million larger than it would otherwise have been. There was a nice interplay of forces between the monetary operations of the government and those of the banks, the net results of which are impossible to unravel. If the government had not added to the liquidity of the economy, the banks might not have been able to collect as much as they did on their loans and the demand for bank credit might have been greater. Also, there might have been less capital flight if the government had pursued more orthodox policies. On the other hand, it is worth pointing out that if the banks had not contracted, the government would not have been able to go as far as it did with its money creation without bringing on a depreciation of the peso.

An alternative way of looking at the gains from the silver policy is to recall that it was originally designed to provide funds for the service of the foreign debt. Had this resource not become available, Cuba might have defaulted like most other Latin American countries. Insofar as the silver profits merely went to maintain expenditures abroad which otherwise would not have been made, all that Cuba gained were such benefits as accrue to a debtor who maintains a good reputation. Perhaps this, too, might be regarded as an important gain, in terms of credit standing and moral effects upon foreign investors, although up to date the sacrifice of maintaining the debt service has not paid off in any very obvious form. Such speculations, however, as to what might have happened if the silver policy had not been pursued are rather tenuous, and in any case do

not call in question the verdict that this policy did bring economic gains, directly or indirectly.

A third point in favor of the silver policy is the fact that it permitted a more gradual transition to a new currency system. The main problem posed by the establishment of such a system was how to manage the transition without an excessive impairment of confidence. A sudden conversion undertaken at a time of deep depression was very likely to produce large-scale capital flight. The silver policy certainly did not altogether avoid this; exports of capital, on the contrary, seem to have attained considerable volume, particularly in 1939, when the silver policy was mismanaged through overissues. Owing to the gradual character of the transition, however, its ill effects in this respect may perhaps have been less than if more abrupt measures had been attempted. This does not mean that the haphazard procedures of the middle thirties were superior to a well-planned monetary reform. One may doubt, however, whether under prevailing economic and political conditions the execution of such a reform would have been possible.

Finally, one may venture the guess that the gradual character of the transition was of advantage also with respect to the timing of deficit spending. A more efficient and complete monetary reorganization probably would have enabled the government to withdraw part of the dollar circulation within a short period. The chances are that these reserves would then have been used up very rapidly, leaving little or nothing for later years. The procedure of issuing limited amounts of currency at a time, thereby stretching resources over a number of years, may have constituted a wholesome check upon reserve utilization.

## CHAPTER IX

### THE RETURN OF THE DOLLAR

THE GOVERNMENT'S ENDEAVORS to control exchange depreciation, described in a previous chapter, had been more ingenious than successful. All in all, the best that a sympathetic observer could say was that in their absence depreciation might have gone somewhat further. There appears to have been a feeling in Cuba that it was preferable to stabilize the peso at 90.00, which was the average rate for 1940, rather than continue the attempt to push it back to par. A tentative recommendation to that effect was made by Pérez and Pazos,<sup>1</sup> and the idea also seems to have existed in government circles. Soon, however, these views were radically revised in the light of wartime developments.

#### I. THE PESO GOES TO A PREMIUM

At the outbreak of war in September 1939 the peso had appreciated sharply, owing to the speculative upsurge in sugar prices and the expectation of large wartime profits for Cuba. From a rate of 87.67 on September 1 it advanced to 94.59 on September 8. This, however, proved to be a false alarm, for when on September 11, the American sugar quota system was suspended and sugar prices thereupon broke badly, the peso dropped back again, reaching 88.14 on September 20. In November it touched 85.58.<sup>2</sup>

<sup>1</sup> *El Problema Monetario*, p. 138.

<sup>2</sup> The suspension of quotas hit Cuba particularly hard, because it not only forced down the price of sugar in the American market, but also caused the American duty on Cuban sugar to revert from the trade-agreement rate of 0.90 cents per pound to its original level of 1.50 cents. This was the effect of a clause in the 1934 trade agreement, which made the American concession on sugar dependent on the continuation of the quota regime. Quotas were subsequently reinstated on December 26, and a supplementary trade agreement lowered the duty to 0.75 cents per pound.

Levels as low as these were not registered again during the following year, but in other respects the trend of events in 1940 was not encouraging for Cuba. The average warehouse price of sugar, which in January 1940 had been 1.53 cents per pound, fell to 1.17 cents in September. Sugar exports shrank alarmingly; in September they amounted to no more than 84,000 long tons and in December to only 57,000, compared with 279,000 and 225,000 tons during the same months of 1939. The receipts of the Stabilization Fund during the latter part of 1940 were so low that the government had to purchase one million dollars in the market in order to find the exchange for its debt service.

Early in 1941, however, the outlook began to improve and by the end of that year a complete reversal in the Cuban situation had taken place. The rise in American national income and the decline in sugar receipts from the Philippines and Hawaii, caused by shipping shortages, combined to drive up the price of sugar in the United States market. American import quotas had to be raised repeatedly during the year. Cuban sugar exports were aided further by the reallocation of various unfilled quotas, as well as by sizable British purchases. As a result, these exports rose from 1,989,000 long tons in 1940 to 3,196,000 in 1941.<sup>3</sup> The average sugar price in Cuba went up from 1.28 cents per pound in January 1941 to 2.27 cents in December, and the peso, which in January was being quoted at 91.64, climbed back to par by the end of the year. In January 1942 the average sugar price stood at 2.53 cents, and the peso was being traded at a small premium.

In November 1941 negotiations were opened for the sale to the United States and Great Britain of the entire exportable sugar crop to be harvested in 1942, and in January 1942 a contract was signed calling for a minimum price of 2.65 cents per pound of raw sugar and 2.50 per pound for the sugar con-

<sup>3</sup> The American sugar quota was raised altogether five times during 1941. The reallocation of unfilled quotas, except that of the Philippines, brought the number of increases in the Cuban quota to six. British purchases from Cuba during 1941 were reported to have amounted to 500,000 tons. See *Anuario Azucarero de Cuba, 1942* (Havana, 1942), pp. 11-12.

tent of molasses.<sup>4</sup> The size of the crop was left open, with the understanding that it was to be as large as could be produced. Eventually it was fixed at 4,675,000 short tons, raw value.<sup>5</sup>

The preparation and completion of so large a crop, which came within about 20 per cent of the record output of 1925, required a substantial outlay of cash. Currency needs were further increased by a decree ordering an increase of 50 per cent in the wages of the "industrial sector" of the sugar industry during the 1942 crop.<sup>6</sup> Business soon reached boom tempo, and prices began to rise under the double stimulus of higher income and growing shortages of imported materials. The inelastic peso supply proved inadequate to meet the needs of the situation. Early in 1941 it had still been redundant, as shown by the discount. But as monetary requirements grew and more buyers of pesos appeared in the exchange market, the discount narrowed progressively. By September, it was down to one-half of one per cent, and in December it disappeared completely.

With the peso at par, the advantage of paying out pesos instead of dollars in the internal market vanished. It was logical, therefore, to expect that the dollar would return to the internal market, and that the demand for pesos would then let up, the two currencies continuing to circulate at par with one another. This expectation was fulfilled so far as the return of the dollar is concerned. From July 1941 to June 1942 a total of 87.3 million dollars was imported by the banks and by the United States Treasury,<sup>7</sup> of which 51.4 million went into circulation, while 35.9 million remained in the banks. Unexpected, however, was the premium upon the peso which developed in January 1942 and which carried the peso to a high of 101.25 in February. This phenomenon caused a good deal of comment, and various explanations were put forward. The most current opin-

<sup>4</sup> For details of the contract, see *Anuario Azucarero de Cuba, 1942*, p. 81.

<sup>5</sup> Of this, a small part was reserved for Cuban consumption. The remainder was available for export, together with a carry-over from 1941. A substantial amount of blackstrap molasses was included in the sale.

<sup>6</sup> Decree 100, December 15, 1941.

<sup>7</sup> The American Treasury shipped currency in order to meet obligations under the sugar purchase agreement.



ion was that the premium was caused by the increase in the cost of shipping currency to Cuba, occasioned chiefly by the rise in war-risk insurance rates during the peak of the Caribbean submarine campaign.<sup>8</sup>

## 2. CAUSES OF THE PESO PREMIUM

The basic causes of the premium appear to have been somewhat more complex, however, than the "currency shipping cost" explanation would make appear. The latter factor was only one of several which were jointly responsible for the premium and determined its magnitude.

It is clear that an increase in shipping costs would affect not primarily the relation between the peso in New York and the dollar in Havana, but the relation between the dollar in New York and the dollar in Havana. In other words, one might have expected the appearance of a premium on Havana dollars over New York dollars, equal to the cost of shipping currency. Such a premium did in fact arise, although it appeared only in the guise of service charges by the banks. The banks did not alter the customary charge upon dollar transfers from New York to Havana, which for many years had been one-tenth of one per cent.<sup>9</sup> They refused, however, to pay out dollar bills of small denominations against such transfers, since this would have forced them to import the currency at a cost not covered by the transfer charge. Payment was made only in large denominations, or through the Clearing House.

Many businesses, however, needed currency in small denominations for making up payrolls. For the service of importing such currency the banks imposed a charge equal to the cost of transportation. This, of course, amounted to a premium on small dollar notes in Havana over New York dollars.<sup>10</sup> Con-

<sup>8</sup> See *New York Times*, February 6, 1942; *Journal of Commerce*, February 25, 1942.

<sup>9</sup> This rate had been established by the Federal Reserve agencies in Havana, and the banks had maintained it after the withdrawal of the agencies.

<sup>10</sup> The banks' practices in dealing with this situation were not entirely uniform. In a few instances, they absorbed part or all of the transportation costs, in others they charged the customer with the cost of a specific shipment, in still others they endeavored to distribute the cost of various shipments among a number of customers. On the whole, however, the description given above

currently, the banks imposed a corresponding premium upon payments in Havana in small dollar denominations against dollar deposits in Havana.

The difficulty of obtaining dollars in small denominations was the first cause of the peso premium. The owner of a dollar deposit in a Cuban bank found it more profitable to bid for pesos, of which small denominations were plentiful, than to pay the banks' charge for importing small currency.<sup>11</sup> This condition continued until the peso had risen to a premium equal to the cost of bringing in dollar currency. At that point, which was somewhere in the neighborhood of  $\frac{3}{4}$  per cent above par, peso purchases ceased to be more profitable than dollar imports, and the premium might have been expected to become stabilized.

The fact that the peso did not become stabilized at that level, but rose as far as 101.125, nearly  $\frac{1}{2}$  per cent beyond the equilibrium point, is evidence that shipping costs were not the only factor working against the dollar. Of the other elements, the most important probably was the fact that after 1938, when the dollar disappeared from circulation, the peso had become firmly entrenched in the habits of the public. The reintroduc-

adequately portrays the essence of the banks' procedure. Since currency could be shipped by various routes — by registered airmail, New York-Havana, or Railway Express New York-Miami and airmail Miami-Havana, etc. — a uniform schedule of transportation costs cannot be given. Variations in insurance rates caused preferences for alternative routes to change from time to time. The following rates appear to have been the cheapest during the first week of February 1942, when the premium was at its height:

| <i>Denomination</i> | <i>Via</i>                                        | <i>Cost per<br/>\$100,000</i> |
|---------------------|---------------------------------------------------|-------------------------------|
| \$100.00            | Registered airmail                                | \$442.55                      |
| 50 00               | Registered airmail                                | 450 10                        |
| 20 00               | Registered airmail                                | 472.74                        |
| 10.00               | Registered airmail                                | 510 50                        |
| 5 00                | Registered airmail                                | 586.00                        |
| 1.00                | Railway Express to<br>Miami, airmail to<br>Havana | 606.00                        |

<sup>11</sup> Of the existing 87 million of silver certificates, 67 million were in denominations of 20 pesos or less, and for reasons connected with the monetary habits of the Cuban public the banks held a very high proportion of these.

tion of the dollar, therefore, was likely to meet with a certain amount of resistance under any circumstances. The initial appearance of a small peso premium occasioned by shipping costs intensified the psychological handicap, and the inauspicious start of the war was another contributing factor.<sup>12</sup> Further evidence of the eclipse suffered by the dollar is the report that in certain parts of the island retailers discounted American currency by as much as 1½ per cent, and that sugar mill workers protested against payment of their wages in dollars.<sup>13</sup> Tax collectors, customs officials, and post offices for a brief period refused to accept dollars.

If there had been a general refusal to recognize the equivalence of dollars and pesos in retail transactions and wage payments, the peso might have risen much further. Cases like the above remained isolated instances, however, thanks in part to the warnings issued by the Treasury. Hence Gresham's Law very soon began to make itself felt. Whereas during the thirties it had helped to prevent a major depreciation of the peso, it now served to support the dollar. With a peso premium exceeding the cost of shipping small dollar currency into Cuba, it became more profitable to pay the banks' service charges than to bid for pesos. It also paid to convert pesos into dollars instead of spending them directly. Aided by these forces, and by a series of government measures discussed below, the dollar soon recovered to a point where its discount no more than equaled dollar shipping costs.

In summary, the peso premium was partly a general exchange problem and partly one of currency denominations. The prime mover was the growing demand for small circulating medium, induced by the expansion of business. The charges that banks imposed upon small dollar currency caused the peso, which was freely available in small denominations, to go to a premium at least equal to these charges. To this extent the view that regarded the cost of currency shipments as the cause of the premium was correct. The premium, however, went

<sup>12</sup> In this connection one may recall the run upon the Canadian branches in the summer of 1940, which points up the sensitivity of the Cuban public to war developments.

<sup>13</sup> *New York Times*, February 14, 1942.

higher than could be justified by the "shipping cost" theory, and this can only be explained by reference to psychological elements adverse to the dollar. After the initial resistance had been overcome, the premium dropped back to the level warranted by bank charges.

### 3. MEASURES TO CURB THE PREMIUM

The premium reached its high on February 5, when the peso was quoted at 101.125. This situation, which naturally attracted a good deal of attention, was agreeable neither to the American nor the Cuban government. On the American side it was feared that the peso premium might be regarded as indicative of a general weakness of the dollar, instead of as the result chiefly of technical factors. There was also the danger that a further rise in the peso might require the United States to pay a higher dollar price for the next sugar crop. For Cuba it meant the emergence of new monetary disturbances, just when the old ones appeared to have been conquered. Cuban sugar exporters stood to suffer a reduction in profits if the situation should get out of hand.

The first action taken by the Cuban government in support of the dollar was a resolution, dated December 31, 1941, authorizing banks to adjust the proportion of dollar and peso reserves to that of their deposits.<sup>14</sup> The obligation to keep a certain fixed proportion of the legal reserves in pesos was thereby eliminated.<sup>15</sup> This measure freed some of the peso currency previously immobilized in bank reserves and brought a certain amount of relief. The next step was a warning to all government agencies not to refuse dollars offered in payment of taxes. Coupled with this was a decision to pay government salaries and other obligations in pesos and dollars without distinction. A few days later the Cuban Treasury issued a general reminder to the public that United States currency was full legal tender, and warned that speculators attempting to depreciate the dollar would be prosecuted.<sup>16</sup> Another measure was the reduction to

<sup>14</sup> *Gaceta Oficial*, January 3, 1942.

<sup>15</sup> On June 24, 1941, when the peso had risen to 98.66, the original proportion of 75 per cent, fixed in 1938, had been reduced to 56 per cent.

<sup>16</sup> *New York Times*, February 14, 1942.

one per cent of the proportion of exports proceeds that had to be delivered to the Stabilization Fund as of February 25.<sup>17</sup> Owing to the premium, the Fund had ceased to be a source of profits and even threatened to cause losses to the government. The reduction had no significant influence upon the exchange situation, but served to protect the Treasury against the need to supply pesos at par, when in the market they were selling at a premium.

More important than any of the preceding measures was the law of May 2, 1942, which authorized the issue of silver certificates against dollars or gold.<sup>18</sup> The new certificates were to be issued with a seigniorage of 2 per cent; they were not, however, convertible into the assets against which they were issued, but into Cuban silver coins, at the statutory price of 1.2929 pesos per ounce. The reason for this somewhat incongruous device was primarily one of expediency. A certain amount of unissued certificates from the 1938 issue were available, and the plates with which they had been printed still existed. This permitted a considerable saving of time, which was important under the circumstances. A further advantage was that the creation of still another type of currency was avoided. Finally, the use of silver certificates permitted the government to postpone the decision as to the use, if any, to be made of the gold and dollar reserve in case the peso should weaken once more. The law said nothing on this point. Convertibility into silver coins offered no protection, of course, against depreciation to the level of their bullion value.

Unlike previous peso issues, the present law was a purely monetary measure, free from budgetary implications.<sup>19</sup> Its guiding purpose was to absorb the great volume of foreign exchange resources that was accruing to Cuba, and to create a monetary reserve that some day might be turned over to the central bank then being planned. A second purpose was to satisfy the demand for peso currency and to curb the peso premium. In order to provide the government with the neces-

<sup>17</sup> Under the authority of Decree 341 of February 11, 1942.

<sup>18</sup> Law 5, *Gaceta Oficial*, May 4, 1942. The law also authorized the President to reduce legal reserve requirements of banks as low as 12½ per cent.

<sup>19</sup> The seigniorage of 2 per cent left only a very small profit after expenses.

sary dollars, the proportion of proceeds from sugar exports to be delivered to the Stabilization Fund was raised to 10 per cent.<sup>20</sup>

Thereafter the government was no longer forced to sell the dollar accumulations in the fund at short intervals for lack of peso resources. It was now in a position to monetize its foreign exchange receipts. To facilitate the conversion of dollars into gold, an agreement was concluded on July 6, 1942, with the United States Treasury, which provided for the sale of gold to be earmarked in the Federal Reserve Bank of New York. A 120-day revolving credit of up to 5 million dollars was arranged for in this connection.<sup>21</sup>

<sup>20</sup> By Treasury order of June 3, 1942.

<sup>21</sup> The credit arrangement was without major significance, and Cuba made little use of it. It was intended to help Cuba bridge the interval between the purchase of gold and the issuance of silver certificates. In practice, the certificates usually were issued against dollars which later were converted into gold

## CHAPTER X

### EXCHANGE STABILITY AND INFLATION, 1942-1947

THE WAR YEARS brought great changes in Cuba's monetary affairs. Before 1941, Cuba was a "have-not" nation in terms of international purchasing power. At the end of 1947, she found herself very distinctly among the "haves," with exchange resources of over 800 million dollars, which, in Latin America, were second only to those of Argentina. The total money supply, which in December 1940 stood at 163.2 million, had expanded to 932.2 million by December 1947.

In striking contrast to these quantitative developments was the virtual absence of qualitative changes in the monetary scene. After the passage of Law 5 of May 2, 1942, providing for issues of pesos (silver certificates) against a 98 per cent backing in gold or dollars, no structural change of any substance occurred. Large amounts of peso currency were issued under this law, but basically the monetary mechanism remained as it was. Meanwhile, as a result of an enormously active balance of payments and a consequent expansion in the money supply, Cuba experienced an inflation of her price level that foreshadowed serious monetary and other problems for the years ahead.

The main fuel for the Cuban war boom naturally was supplied by the sugar industry.<sup>1</sup> With the exception of the year 1943, when shipping and storage space limitations made crop curtailment necessary, the industry was called upon for maximum output every year. All but a minor part of each successive crop was purchased by the United States through the Commodity Credit Corporation. Contract prices remained stable

<sup>1</sup> For a more detailed account of sugar events during the early war years, see the author's chapter on "Cuba: Sugar and Currency," in *Economic Problems of Latin America*, ed. Seymour E. Harris (New York, 1944).

at 2.65 cents per pound for the 1942, 1943, and 1944 crops but were raised to 3.10 cents for 1945, considerable disagreement prevailing each year between seller and buyer as to the "just" price. The value of the successive crops is indicated in the accompanying tabulation.

CALCULATED VALUE OF CUBAN SUGAR CROPS, INCLUDING MOLASSES  
(*In millions of pesos*)

|            |       |            |       |
|------------|-------|------------|-------|
| 1940 ..... | 98.6  | 1944 ..... | 305.2 |
| 1941.....  | 115.8 | 1945 ..... | 251.5 |
| 1942.....  | 250.6 | 1946.....  | 341.5 |
| 1943 ..... | 163.3 | 1947.....  | 657.7 |

### I. MONETARY EXPANSION

Under the impact of the war boom, Cuba experienced a monetary expansion unusual even among Latin American countries during this period. From a low of 139.2 million pesos in 1938, and following a slow rise to 163.2 million in 1940 and 192.4 million in 1941, the money supply bounded upward to 675.8 million in 1945 and 932.2 million in 1947 (year-end figures). This increase was all the more notable because, in contrast to the experience of other Latin American countries, neither governmental deficits nor bank credit played a major role in it (see Table 9). The entire increase was brought about by the intensely active balance of payments. The latter in turn was largely the result of sugar sales but was aggravated by the heavy repatriation of Cuban funds abroad (and curtailment of new capital exports) which took place during the war, partly because of the imposition of a tax upon funds held abroad by Cuban investors and institutions at the rate of 0.15 per cent per month.

The growth in the fiduciary element in the money supply, resulting from the 2 per cent seigniorage taken on peso issues, accounted for barely one per cent of the monetary expansion after 1941. In fact, if the silver bullion behind the issues prior to Law 5 of May 2, 1942, is reckoned at market value instead of at cost (Table 9 adopts the latter procedure) the fiduciary element in the Treasury currency, instead of expanding, is seen to have shrunk between 1941 and 1947, owing to the rise



in the price of silver from its prewar price of 35 cents per ounce to 71.11 cents by the end of the war.

Bank credit, too, played very little part in the monetary expansion; in fact, up to 1945 its role was technically negative. Although bank loans rose by 50.3 million pesos between December 1941 and December 1945, this was more than offset, in a monetary sense, by the simultaneous growth in time deposits

TABLE 8  
MONEY SUPPLY, 1938-1947<sup>a</sup>  
(In millions)

| End of | Silver Coins and<br>Subsidiary<br>Currency |       | Silver<br>Certificates | Dollar<br>Bills | Demand Deposits |       | Total <sup>b</sup> | Adjusted<br>Total <sup>c</sup> |
|--------|--------------------------------------------|-------|------------------------|-----------------|-----------------|-------|--------------------|--------------------------------|
|        | U S                                        | Cuban |                        |                 | Dollars         | Pesos |                    |                                |
| 1938   | .                                          | 8.6   | 38.5                   | 12.6            | 36.4            | 43.2  | 139.2              | 139.2                          |
| 1939   | .                                          | 7.4   | 45.8                   | 14.1            | 26.6            | 52.8  | 146.8              | 146.8                          |
| 1940   | ..                                         | 7.0   | 53.8                   | 19.4            | 31.8            | 51.1  | 163.2              | 163.2                          |
| 1941   | .1                                         | 6.9   | 60.8                   | 29.4            | 47.6            | 47.6  | 192.4              | 192.4                          |
| 1942   | .4                                         | 6.9   | 67.9                   | 49.4            | 73.6            | 63.6  | 261.8              | 276.8                          |
| 1943   | .8                                         | 7.8   | 73.8                   | 80.1            | 123.5           | 71.5  | 357.5              | 373.7                          |
| 1944   | 4.1                                        | 8.2   | 120.8                  | 130.6           | 167.8           | 120.4 | 551.9              | 574.5                          |
| 1945   | 5.1                                        | 7.8   | 179.4                  | 145.7           | 180.0           | 149.9 | 667.9              | 675.8                          |
| 1946   | 5.7                                        | 9.3   | 215.5                  | 170.6           | 190.5           | 190.5 | 782.1              | 780.0                          |
| 1947   | 5.8                                        | 9.5   | 269.2                  | 213.8           | 204.9           | 235.5 | 938.7              | 932.2                          |

<sup>a</sup> Currency, coin, and demand deposits in the hands of the public and Treasury.

<sup>b</sup> Discrepancies are due to rounding.

<sup>c</sup> The data in this table are derived from sources differing in some respects from those underlying the analysis of the money supply in Tables 6 and 9. The slight discrepancies resulting from this procedure for the years 1942-1947 have been adjusted so as to bring the total money supply shown in this table into agreement with the data of Tables 6 and 9.

Sources: Dirección General de Estadística, *Circulación Monetaria y Movimiento Bancario*, various publications of the Cuban Treasury.

of 41.6 millions and in other nonmonetary deposits. The public, in other words, sterilized an amount of money larger than that newly created by the banks, so that the latter's net contribution to the money supply (which includes only demand deposits and currency) was negative during that period. During 1946 and 1947 a sharp expansion of bank credit was made necessary by an avalanche of imports, which raised total loans by 63.7

TABLE 9

MONEY SUPPLY BY ORIGIN, 1938-1947  
(In millions)

| End of | Credit Origin                       |                |                  |                                                            | Money Supply |                                                          |                                |                                                      | International Origin            |                  |      | Money of<br>International<br>Origin,<br>per cent<br>of total |      |
|--------|-------------------------------------|----------------|------------------|------------------------------------------------------------|--------------|----------------------------------------------------------|--------------------------------|------------------------------------------------------|---------------------------------|------------------|------|--------------------------------------------------------------|------|
|        | Treasury<br>credit<br>(seigniorage) | Bank<br>credit | Total<br>(1 + 2) | Bullion<br>value of<br>silver,<br>nickel and<br>other coin | Gold<br>coin | Gold<br>bullion and<br>dollars<br>backing<br>silver cert | Dollars<br>in cir-<br>culation | Dollars<br>in banks<br>and net<br>balances<br>abroad | Total<br>(4 + 5 + 6<br>+ 7 + 8) | Total<br>(3 + 9) | (10) |                                                              | (11) |
|        |                                     |                |                  |                                                            |              |                                                          |                                |                                                      |                                 |                  |      |                                                              |      |
|        |                                     |                |                  |                                                            |              |                                                          |                                |                                                      |                                 |                  |      |                                                              |      |
| 1938   | 47.4                                | 26.1           | 73.5             | 32.4                                                       | .1           |                                                          | 12.7                           | 20.5                                                 | 65.7                            | 139.2            | 47.2 |                                                              |      |
| 1939   | 53.5                                | 36.7           | 90.2             | 36.0                                                       | .1           | 1.2                                                      | 14.2                           | 5.1                                                  | 56.6                            | 146.8            | 38.6 |                                                              |      |
| 1940   | 53.5                                | 40.7           | 94.2             | 36.0                                                       | .1           | 1.2                                                      | 19.4                           | 12.3                                                 | 69.0                            | 163.2            | 42.3 |                                                              |      |
| 1941   | 53.5                                | 30.9           | 84.4             | 36.0                                                       | .1           | 1.2                                                      | 29.4                           | 41.3                                                 | 108.0                           | 192.4            | 56.1 |                                                              |      |
| 1942   | 54.0                                | 34.0           | 88.0             | 36.0                                                       | .1           | 26.2                                                     | 49.7                           | 76.8                                                 | 188.8                           | 276.8            | 68.2 |                                                              |      |
| 1943   | 54.5                                | 26.3           | 80.8             | 36.0                                                       | .1           | 51.2                                                     | 80.9                           | 124.7                                                | 292.9                           | 373.7            | 78.4 |                                                              |      |
| 1944   | 56.9                                | 23.0           | 79.9             | 36.1                                                       | .1           | 151.2                                                    | 134.7                          | 172.5                                                | 494.6                           | 574.5            | 86.1 |                                                              |      |
| 1945   | 58.4                                | 25.5           | 83.9             | 36.1                                                       | .1           | 226.2                                                    | 150.8                          | 178.7                                                | 591.9                           | 675.8            | 87.6 |                                                              |      |
| 1946   | 60.2 <sup>a</sup>                   | 59.5           | 119.7            | 36.6                                                       | .1           | 251.2                                                    | 161.4                          | 211.0                                                | 660.3                           | 780.0            | 84.7 |                                                              |      |
| 1947   | 62.9 <sup>a</sup>                   | 59.5           | 122.4            | 36.8                                                       | .1           | 356.2 <sup>b</sup>                                       | 212.7                          | 204.0                                                | 809.8                           | 932.2            | 86.9 |                                                              |      |

<sup>a</sup> Estimate of seigniorage on 2 5 million dollar issues of copper and nickel during 1916-47 assumed to have amounted to 1 25 in 1946 and 0 6 in 1947, while the 2 per cent seigniorage on silver certificate issues was computed at 0 5 in 1946 and 2 1 in 1947

<sup>b</sup> Including 5-million-dollar gold contribution to International Monetary Fund

Sources Tables 8 and 13; also data supplied by Cuban Treasury.

million at the end of 1947, to a total of 174.4 million. The money supply of internal origin expanded by no more than 28.5 million, to a total of 59.5 million.

Of the total additions to the money supply, only the smaller part was in pesos. Although very substantial amounts of peso currency were issued under Law 5, against the withdrawal of a virtually equal amount (98 per cent) of dollars, they were not nearly sufficient to absorb the rising tide of dollars. Between January 1942 and December 1947 the total volume of certificates outstanding, in the hands of the public, the banks, and the Treasury, rose by 363.8 million (see Table 17). The total of Cuban currency and coin forming part of the money supply (in the hands of the public and of the Treasury) at the end of 1947 amounted to 278.2 million (Table 8). Despite this expansion, the dollar circulation, according to the official statistics, recovered to 219.6 million and thus again accounted for a substantial proportion of the total circulation. It may be added, however, that the volume of dollars actually was a good deal less, because the balance of unrecorded currency movements probably is unfavorable to Cuba, owing to the nature of Cuba's tourist traffic and because the 2 per cent tax on export of money makes dollar bills a favorite means of evasion. Dollar demand deposits, which in 1939 had shrunk to 26.6 million and amounted to only 33 per cent of total peso/dollar demand deposits, meanwhile rose to 204.9 million, equal to 46 per cent of total demand deposits. Thus the dollar once more had come to represent a large, though not dominant, part of the Cuban money supply (Table 8).

That this resurgence of the dollar was permitted to take place was unfortunate from several points of view. For one thing, it undid some of the progress that had been made in conditioning the public to the exclusive use of the native money. To achieve a unified monetary system, susceptible to proper monetary controls, Cuba eventually would have to eliminate the dollar from circulation. Progress toward such a system was made correspondingly more difficult.

A second and more important motive for regret was the implicit failure to centralize Cuba's foreign exchange resources.

The increase in international purchasing power that Cuba reaped from her large active balance of payments was one of the most significant gains of the war period. It provided the island with means to catch up on imports postponed because of the war, and beyond that to finance a long-run industrialization policy and to maintain permanently an adequate monetary reserve. These were the ends to which other Latin American countries were planning to devote their wartime exchange gains. But Cuba — though in proportion to her population she probably had more exchange resources than any other Latin country — was in a less favorable position for their effective use. This was due, of course, to the fact that more than half of these resources were in circulation and in the banks, instead of being centralized in the Treasury or in a central bank.

The short-term exchange assets available to the Cuban economy, as of December 31, 1947, were as follows (in millions of dollars):

|                                                                                        |       |
|----------------------------------------------------------------------------------------|-------|
| Gold cover of silver certificates <sup>2</sup> . . . . .                               | 296.2 |
| Dollar cover of silver certificates . . . . .                                          | 60.0  |
| Bullion value of silver cover of silver certificates<br>(at 71.11 per ounce) . . . . . | 44.1  |
| Dollars in circulation <sup>3</sup> . . . . .                                          | 210.6 |
| Dollars held by banks . . . . .                                                        | 92.4  |
| Net foreign balances of banks . . . . .                                                | 111.6 |
|                                                                                        | <hr/> |
|                                                                                        | 823.9 |

<sup>2</sup> Includes 5 million dollar gold subscription to the International Monetary Fund under Presidential Decree 457 of February 27, 1947.

<sup>3</sup> Based on declared imports and exports of United States currency and coin which probably lead to an excessively high estimate.

Of the total of 823.9 million dollars, only the gold and dollar cover of the silver certificates, aggregating 356.2 million, plus the market value of the silver hoard, which under existing conditions could probably have been realized without difficulty, represented central reserves.

Of the remainder, the part which most easily could, and probably should, have been absorbed into the central reserve through corresponding issues of silver certificates was the

dollar currency and coin in circulation — officially 219.6 million, but actually probably below that figure. It is true that these dollars, even though in circulation, could perform the function of international reserves to a certain extent. In case of an adverse shift in the balance of payments they would tend to be driven out and would ease the pressure upon central exchange resources. It is clear, however, that this dispersion greatly reduced their effectiveness. It facilitated exchange hoarding and, by making the public more exchange-conscious, might even become an incentive to capital flight during a crisis. The uncertainty about the precise amount of dollars remaining in circulation at such a time, moreover, would deprive the authorities of a clear picture of over-all exchange resources.<sup>4</sup> A concentration of the public's dollar holdings in the central reserve was therefore desirable so as to enable the authorities to pursue a more intelligent and effective policy.

A somewhat different matter would have been the concentration of the banks' holdings of dollar currency and foreign balances. These holdings were essential to the banks as a means of balancing their exchange position. It is true that, if the circulation of dollars had been kept to a minimum, the banks' dollar deposits also would have remained at much lower levels. But insofar as dollar deposits did exist, it was essential for the banks to have dollar assets. Moreover, these foreign balances were important to the banks as a source of income and, in some instances, as a means of establishing credit facilities and of attracting business from foreign correspondents. For these reasons, the banks probably would have put up strong resistance against any attempt on the part of the Treasury to centralize their foreign exchange holdings.

Thus, any criticism of the policy that permitted the return of the dollar into circulation and missed the opportunity to build up larger central reserves relates primarily to the dollars in circulation. It must be observed, however, that this policy was to some extent forced upon the Cuban Treasury by the awkward provisions of Law 5, which governed the issuance of

<sup>4</sup> It will be remembered that a false appraisal of these resources in 1938 led to an overissue of pesos and to a depreciation of the currency.

pesos. Under this law, the exchange of dollars for pesos was a one-way street, since no provision was made for the use of gold reserves if and when the peso should require support.<sup>5</sup> The dangers of continued peso expansion without provision for redemption were repeatedly emphasized in the press.<sup>6</sup> Although it is not unreasonable to assume that appropriate legislation would have been passed in case it should have become necessary to support the peso, the Minister of the Treasury, knowing the pitfalls of Cuban legislative processes, had some reason to hesitate in expanding the circulation even with a 98 per cent reserve.

## 2. PRICES

Cuba was drawn into the whirlpool of her wartime inflation with only the vaguest notion as to the true dimensions of the phenomenon. The only price index that is available to measure the rise is one of food products, which has been compiled since 1937.<sup>7</sup> It shows that between September 1939 and September 1947 the level of food prices (outside Havana) rose from 95 to 249, an increase of 162 per cent. Alienes estimates that the total cost of living, for which no index exists, rose 80 per cent between September 1940 and September 1944.<sup>8</sup> On the same basis it may be estimated that by the end of 1947 the cost of living was up about 125 per cent from September 1939.

Measured by Latin American standards, this rise was not extraordinary. It considerably exceeded the increase in Uruguay, but was more moderate than increases in Mexico and Brazil. What gave a certain special significance to the 125 per cent increase, however, was the fact that in absolute terms even Cuban prewar prices had not been particularly low. Cuba was

<sup>5</sup> Although interpretations of the law differ on this point, it was believed that the Cuban Treasury had the right to conduct such stabilization operations with the dollars against which pesos had been issued and which had not yet been converted into gold. For this reason, the Treasury tended to delay its final gold purchases and to keep on hand a few tens of millions of dollar currency.

<sup>6</sup> See *Cuba Económica y Financiera*, April 1943, p. 6; June 1943, p. 5.

<sup>7</sup> Ministerio de Agricultura, *Boletín de la Oficina de Números Índices* (Havana).

<sup>8</sup> See Julián Alienes, "La Economía Cubana en 1944" (Havana, 1945), distributed in mimeograph by the Cámara de Comercio de la República de Cuba.

a "dollar country," heavily dependent upon American-made consumer goods, and hence her prices were in many respects similar to American prices. Wartime inflation, although not exorbitant, now had made Cuba an internationally expensive country.

The causes of this inflation were on the whole much less complex than those that contributed to inflation in other Latin American countries. With more justification than elsewhere it could be said that the entire development stemmed from one single source — the high volume of sugar exports; it seemed as if in Cuba, where everything rests on sugar, even inflation was a "one-crop" phenomenon.

Government deficit financing of the ordinary type played very little part. The Cuban government could not borrow much in any case, having no central bank to turn to and only very limited access elsewhere to voluntarily granted credit.<sup>9</sup> It could have continued its silver issues once the dollar had returned to circulation in sufficient volume to prevent substantial peso depreciation, the seigniorage then taking the place of central bank credit creation. This the government refrained from doing, however, and instead covered most of its rising expenditures through additional taxation.<sup>10</sup> It was greatly aided by the automatic rise in tax yields as a result of rising prices and incomes, and by the fact that imports and hence tariff revenues rose almost continually, contrary to the experience of most other Latin countries.

Commercial bank credit, too, did not play nearly so inflationary a role as it did in many other countries. The net contribution of bank expansion to the money supply from 1939 to 1947 was no more than 22.8 million. Up to 1945 it was in fact negative, as pointed out above, because the volume of demand deposits that the banks created through new loans and security purchases was less than the amounts that the public

<sup>9</sup> From time to time, the government sold three-month bills to the market, mainly to the banks, under the authority of Law 5 of May 2, 1942, which were serviced promptly. The government may also have been in a position to draw upon certain special and other funds that were under its control.

<sup>10</sup> The government might have encountered difficulties in securing the necessary silver at that time, but this probably was not the reason for its restraint.

put into savings deposits and thereby abstracted from the money supply.

The scarcity of imports which contributed to inflation throughout Latin America was likewise less extreme in Cuba than elsewhere. Cuban imports increased in each year following 1940, whereas many other countries experienced temporary or continuous declines. In the matter of higher prices of imports, which in itself was an important inflationary factor, Cuba also was specially favored, for the United States agreed to supply certain essential foodstuffs at fixed prices, in return for the limitation imposed upon Cuban sugar prices.

The fact that inflation became as intense as it did was attributable primarily, therefore, to the very high level attained by exports. From 127.3 million pesos in 1940 they rose to 772.7 million in 1947, an increase of 507 per cent, which was exceptional even in wartime Latin America. The inflationary impact of this export boom was intensified by various factors in the Cuban environment. For one thing, the Cuban economy seems to have been less able than some others to improvise substitutes for lacking imports, although its failure in that respect was by no means complete, as was demonstrated, for instance, by the continuation of the building boom in the face of rising shortages. For another, there was the strength of the labor unions and, from late in 1944, a government that favored their demands. Repeated wage increases throughout wide sectors of industry were instituted on government orders. There was also considerable lack of restraint on the part of many merchants who profiteered with imported merchandise, particularly where United States export ceilings had kept the cost of such merchandise reasonable.

Equally responsible for the unchecked progress of inflation was the Cuban government's failure to take effective counter-measures. There are three broad types of measures that Latin American governments employed during the war: (1) restriction of purchasing power through monetary and fiscal controls; (2) increase in supplies, through stimulation of domestic production and imports and through export restrictions; and (3) direct price control. The Cuban government tried its hand at



all of these, with the exception of monetary controls, but not on a sufficient scale or with sufficient energy to achieve worthwhile results.

Taxes were raised and new ones instituted, but mostly of the indirect kind, which tended to raise prices still further and which, in any case, were not severe enough to make much of a dent in rising purchasing power. Certain import duties were lowered and supply contracts with the United States were arranged, all of which probably helped, as did the temporary prohibition of meat and certain other exports. But these things, too, were not commensurate with the magnitude of the problem. The ceiling-price system of the ORPA (Office of Regulation of Prices and Supply), which mainly concentrated on foodstuffs, lacked effectiveness, owing to the familiar difficulties of administration which beset direct price control in most Latin American countries. Rent control was a favorable exception, but foodstuffs and other cost of living items rose almost unchecked. Only during a brief period in 1944, immediately following the election of President Grau, was a really intensive and temporarily successful drive made to hold prices down. In the face of the general weakness of its anti-inflation program, the government could claim credit only for its abstinence from large-scale deficit spending.<sup>11</sup>

Of particular interest, from the viewpoint of the present study, is the complete absence of all monetary anti-inflation measures. Without a central bank, it is true, such measures would have been technically more difficult, but not impossible. If undertaken, they should have been primarily directed, not against bank credit expansion, which remained well within bounds, but against the enormous increase of funds in the hands of the public. Action to absorb and sterilize part of these funds, incidentally, could have been combined with a campaign to create a broader market for government securities. The plethora of idle funds seeking outlets provided an usual opportunity for overcoming the habitual resistance of the Cuban public to this kind of investment. The sale of govern-

<sup>11</sup> Even so, the government might well have gone one step further by curtailing its large public works program.

ment notes for sterilization purposes, perhaps backed by gold, might have been a means of combining both ends.

In actual fact, insofar as any policy was pursued, it was the opposite of a sterilization policy. The most important measure affecting the volume of money was the much-cited tax on investments abroad, which was intended, and in some measure probably availed, to bring about a repatriation of Cuban capital abroad. In a sense, the tax performed a function elsewhere performed by exchange control. In times of depression, a good deal might be said for it. During an inflation, however, it merely forced additional purchasing power into an economy that already had too much of it. Its timing, therefore, was far from fortunate.<sup>12</sup>

If steps could have been taken simultaneously to centralize the additional exchange resources thus flowing into the banks, the tax might have been defended on the ground that it strengthened the official reserves of the country. But, since this was not done (and might not have been advisable for other reasons), Cuba probably got more bad than good from this measure. The government's monetary policy, therefore, was the weakest spot in a generally feeble anti-inflation program.

To Cubans looking into the future, it was obvious that the unusually great rise in prices and costs had created a serious problem for their sugar industry. This was already apparent in the difficulties that Cuban producers had in closing with the Commodity Credit Corporation for the sale of the 1945 and 1946 crops. The price increases demanded by the Cubans looked much larger in the light of prices in the United States than of those in Cuba. When the sugar situation should have shifted once more from a sellers' to a buyers' market, this disparity was likely to be increasingly felt. Tariffs and other trade restrictions, to which many Latin American countries were looking for protection against the consequences of war-time inflation, would be of no help to an export crop. Devaluation would be technically difficult, given the existing monetary situation, and probably undesirable for other reasons. But cost

<sup>12</sup> It has been argued, however, that the war would have brought about some repatriation in any case, and that the tax merely intensified this trend.

and price reductions, the orthodox remedy, were sure to be a painful process and of rather uncertain promise. The long-run future of Cuban sugar remained as uncertain as before the war.

### 3. EXCHANGE RATE

The peso rate, which during the thirties had been the visible expression of Cuba's monetary troubles, remained practically stable after the premium early in 1942 had been overcome. During 1943 the phenomenon reasserted itself but with less intensity, and thereafter virtual parity was maintained, usually with a slight tendency toward a peso premium.

One of the factors that at times tended to push up the peso continued to be the need for small denomination currency, which had to be imported from the United States. Although eventually the United States Treasury undertook to make currency shipments free of charge, in connection with payments for sugar, the amounts do not seem to have been quite sufficient to meet rising needs. These needs were intensified by the request of the Cuban government that the sugar financing be done as far as possible in pesos, a request which from a broader viewpoint was of course perfectly justified, and with which the banks collaborated. Another factor creating a preference for pesos was the war control over large-denomination dollar bills. It required the banks to report the names of customers depositing bills larger than 100 dollars, which naturally produced universal reluctance to handle such bills.

A phenomenon *sui generis* was the premium on fractional currency, which made itself strongly felt toward the latter part of 1943. On one-cent coins the premium in December 1943 was as much as 10 per cent. This premium, which occurred in many Latin American countries, was obviously due to a shortage of coins in relation to rising prices and business volume, supplies of coin being less elastic than those of banknotes.<sup>13</sup> The pres-

<sup>13</sup> During the war period, numerous Latin countries endeavored to mint additional coins or to place orders for minting in the United States, but scarcity of silver and other metals frequently frustrated their intentions.

sure was gradually eased through the importation of United States coins.

Although up to the end of 1947, there never appears to have been any outward evidence of weakness on the part of the peso — the tendency during the early war period being rather toward a weakness of the dollar — the market nevertheless seems to have passed through some weak phases not observable to the general public. In the dead season of 1945, for instance, it was said that a slight discount on the peso had been forestalled only through the willingness of some of the banks to carry somewhat longer peso positions than their trading practices ordinarily allowed for. This weakness, however, which was produced by the inelasticity of the peso circulation, rectified itself as the progress of the new sugar crop gave rise to greater demand for pesos. The Treasury from time to time engaged in small-scale stabilization operations, supplying the banks with dollars from its working balance and possibly also from the dollar currency held as backing for peso notes, receiving in return from the banks an equivalent volume of notes. These situations, however, were only temporary weak spells. Up to the end of 1947, no basic weakness had manifested itself in the exchange situation, since the large world demand for sugar continued to give strong support to the balance of payments.

## CHAPTER XI

### BANK POLICY

THE PRECEDING ACCOUNT of Cuban monetary events has stressed repeatedly the role played by the banking system. In this chapter, we shall survey some of the policies that the banks have pursued and the problems they have had to face.

The foreign banks that make up most of the Cuban banking system have long been in an unusual and rather uncomfortable position.<sup>1</sup> The majority of them were established in Cuba before the crash of 1920 in order to participate in the general expansion of American interests which followed upon the elimination of Spanish rule. At that time the foreign banks were dwarfed by the three great domestic banks with their extensive branch systems. After the crash foreign banks were joined by a few more foreign institutions, which partially filled the gap left by the disappearance of most of the domestic banks. Very few domestic banks were established during the interwar period, and this left the foreigners in the position of being practically the sole suppliers of credit in the island — a situation which, at least for the banks which had entered before 1920, was unexpected.

Under the stimulus of the record World War II boom, a number of domestic banks sprang up, some of them with a substantial number of branches. These banks were very active, and their operations somewhat reduced the preponderance of the foreign banks. Their appearance, moreover, tended to produce a realignment among the older banks. The distinction between foreign and domestic banks lost some of its importance

<sup>1</sup> The banks are: (1) the National City Bank of New York, (2) the Chase National Bank of the City of New York, (3) the First National Bank of Boston, (4) the Royal Bank of Canada, (5) the Bank of Nova Scotia, and (6) the Bank of China (since 1945). The Canadian Bank of Commerce maintained a Cuban branch until 1945.

as compared with that between the banks that were members of the Havana Clearing House — all the foreign banks and a few of the older domestic banks — and those that were not.

It is too early to say whether or not the appearance of the new banks marked the beginning of a substantially new phase in Cuban banking. Their permanent significance cannot be appraised until the transition to more normal conditions has been effected. Up to the end of 1947, in spite of their aggressiveness, they had not brought about a major change in the structure of bank credit. The main burden of supplying the island with credit continued to rest upon the foreign banks.

It is not quite clear how far the foreign banks were prepared to shoulder the responsibilities that the disappearance of the native banks in 1920 forced upon them. Naturally they could not duplicate the widespread net of branches that the three largest of the extinct Cuban banks had operated during the preceding boom period. Thus a good number of localities remained without direct banking services until the wartime growth of the domestic banks brought some improvements in that direction. In addition to these inevitable geographical limitations, some of the foreign banks also appear to have restricted their business to certain specific types of financing. In general, however, the foreign bankers in Cuba are naturally reluctant to admit that they are not extending as much sound credit as is in their power to grant.

Basically, the limitations imposed by foreign banks upon their Cuban business stem not so much from arbitrary specialization upon certain types of operations, as from the desire to limit risk. Some of the foreign banks have experienced staggering losses in Cuba. Bankers believe that even after the recoveries of the war period, and adding the substantial profits made during good years, the Cuban operations of some of these banks still show a net loss over the entire period. The banks have suffered not only from the successive sugar crises of the early twenties and the early thirties, but also from the various moratoria which began in 1933, from the legal tender law of 1938, and from the consequences of certain deficiencies in the commercial law that at times have impeded the effective en-

forcement of their claims. Thus the banks have been forced to set extremely high standards of quality for their loan business. This has left wide areas of agricultural and of small industrial and commercial financing uncared for, because of the frequently substantial risk involved.

It is clear that this approach to credit problems must lead to an undesirable inflexibility, all the more so in the case of those foreign banks whose Cuban operations are controlled rigidly by their head offices in the United States and Canada. By allowing their local managers a higher degree of freedom, the foreign banks undoubtedly could adapt themselves better to local conditions and expand their operations. In view of the heavy losses suffered in the past, however, and of the magnitude of Cuban operations in relation to some of the banks' entire capital, it is not surprising if boards of directors prefer to keep a tight rein on commitments in Cuba. The fact that all such commitments, no matter how well the risk may seem to be spread locally, are in fact dependent upon the fate of sugar in the international markets, and thus basically are far from diversified, goes some way to justify the policy of remote control.

Most of the foreign banks do not feel at all comfortable in the position of dominance which they occupy. It exposes them to political dangers against which only the existence of a strong domestic banking system could offer protection. Had there been such domestic banks, their influence and public concern for their solvency might have caused the moratorium laws, for instance, to be less sweeping. Since the foreign banks can hardly fail, the government need not be too considerate with them.

A further reason why enlightened foreign bankers would welcome the appearance of more domestic competition is the expectation of a favorable influence upon business. New domestic banks will make loans that the foreign institutions are afraid to touch; thus their competition in some ways would tend to help rather than weaken the latter. Unfortunately the very strength and soundness of the foreign banks have made the creation of new domestic banks difficult. It was only upon the

flood of wartime liquidity that a number of new institutions could be launched. Even then the best customers normally preferred the safety of the foreign banks. Hence a newly established bank is in danger of getting a number of less desirable accounts and may encounter difficulties during a depression.

This leads to a reflection regarding a basic dilemma of Cuban credit conditions. The risk of many types of credit is so high that only an exorbitant risk premium could cover it. There is, of course, some premium that will cover any kind of loss ratio, but banks cannot charge such rates. Moreover, a bank usually prefers to pass by certain types of potentially highly profitable business rather than run the risk of finding itself involved in litigation, foreclosures, and other inconveniences. Hence the conclusion may have to be faced that the credits that can safely be given within the limits of practicable risk premia are insufficient, at certain times, for the maintenance of full employment, and particularly for the development of neglected sectors of the economy. A banking system that attempted to meet these needs fully would probably be exposed to periodic insolvency. To overcome this divergence between private and social cost, government action will probably be required.

With all these shortcomings, however, the Cuban banking system has had the undeniable and very great merit of virtually perfect solvency. Since the collapse of the domestic banks in 1920, Cuba has been almost free from bank failures. Considering the rigidity of the monetary system and the absence of a lender of last resort, this is a remarkable achievement and has been possible only because the system consisted predominantly of large foreign banks. This achievement must be taken into account in appraising the policies followed by the banks in the fields of credit, foreign exchange, and reserves, which will be reviewed in the following pages.

## 1. CREDIT POLICY

Within the broad framework of the banks' generally very conservative credit policy, three aspects attract particular interest: (a) the sharp shrinkage of credit during the twenties and middle thirties, (b) the unequal distribution of credit



among different branches of the economy, which continues up to the present, and (c) the structure of interest rates.

#### A. THE SHRINKAGE OF BANK CREDIT

The shrinkage in the volume of bank loans which continued almost uninterruptedly from the middle twenties to 1937 presents a remarkable picture (see Table 10). From a high of 227.8 million dollars/pesos at the end of 1926, loans declined to 163.6 million in 1930, to 112.4 million in 1932, and 69.2 million in 1937.<sup>2</sup> Even more striking is the reduction in the *money supply of bank credit origin* during the period for which it can be calculated — a decline from 110.1 million dollars/pesos in 1930 to a low of 15.7 million in 1936 (see Table 6). In part this shrinkage of bank credit was due to the increasingly cautious policies adopted by the banks. Its major causes, however, were of a different nature.

In the first place, the high loan total of 227.8 million in 1926 still reflected the existence of frozen loans remaining on the books after the 1920 collapse, to which others were added later as the world crisis deepened. A good share of the reduction in bank credit up to 1937 is accounted for by the gradual liquidation of these frozen credits; even as late as 1945 this process was still going on. The liquidation took several forms. In some cases properties were taken over from debtors and, occasionally, were transferred to subsidiaries created by the banks to operate them; in other cases part or all of the credits were eventually collected; and in still others they were gradually written off against reserves supplied largely by the head offices. The collection of old credits and also the resale to Cubans of properties taken over had deflationary effects upon the Cuban money supply.<sup>3</sup> The write-offs, which were substantial, did not have this effect. They merely represented a forced

<sup>2</sup> The 285.9 million of bank credit outstanding at the end of 1920 was a wholly abnormal phenomenon produced by the Dance of the Millions.

<sup>3</sup> Some of the sales of properties taken over were made to foreign interests and did not reduce the Cuban money supply, unless these interests paid with funds they happened to have in Cuba. A large part of the sales made to Cubans took place during the period of wartime inflation, when their deflationary impact was salutary.

gift to Cuba by American bank stockholders, for which Cuba unfortunately had little to show except rows of impressive residences in the suburbs of Havana.

A second factor in the continued shrinkage of bank credit was the adjustment of monetary transactions to the lower level of sugar prices and exports that prevailed during the thirties. Although the impoverishment of the sugar companies made them more dependent upon bank credit than before, the monetary volume of their operations had shrunk tremendously and therefore probably also their credit needs. The tighter policy of the banks in the face of the financial weakening of their clients intensified the reduction of credit on this score.

A third factor influencing bank credit was the credit money creation by the Treasury, through the seigniorage element inherent in successive silver issues. In this respect, the Cuban situation during the thirties resembled that of the United States. As the government created more and more money, the demand for bank credit from private borrowers underwent a relative or even absolute reduction. But whereas in the United States governmental money creation was assimilated to the normal forms of money creation, since the government borrowed from the banks, in Cuba it assumed the more direct form of fiduciary issues.

The Cuban Treasury thus was offsetting part of the deflationary effect of bank credit liquidation. This was hardly a deliberate policy; the Treasury's motives in pursuing the silver policy were purely of a revenue character, and in a sense the Treasury was fortunate that the contraction of bank credit permitted the pursuit of this policy as far as it did. Had the banks made a determined effort to maintain their loan business, the money supply would have been correspondingly larger and the saturation point that marked the start of serious depreciation would have been reached earlier.

The final factor making for a curtailment of bank credit was the active balance of payments during the middle thirties, with its consequent increase in the money supply of external origin. This factor, however, was not present during the years following the cyclical peak of 1937. It reasserted itself strongly in

1941 and was the main reason why the enormous wartime rise in money payments could be negotiated with only a minor expansion of bank loans (see Table 18).

The fact that the *money supply of bank credit origin*, as contrasted with the volume of *bank credit* as such, declined even more sharply than the latter was due to two further circumstances. In the first place, an increasing proportion of the demand deposits that the banks had created through their lending was converted by the public into time deposits, which do not form part of the money supply in the sense of the term as here used.<sup>4</sup> To that extent, therefore, bank lending did not lead to an increase in the money supply, and the money supply of bank credit origin was correspondingly less. In the second place, the writing off of uncollectible loans against reserves transferred from the head office resulted in a decrease in bank credit and hence in the money supply of bank credit origin, but did not affect the total money supply. The latter merely underwent a change in its structure as a result of these write-offs, money previously appearing as of credit origin now showing up as of external origin, owing to the increase in the foreign balances of the banks (or the reduction of their foreign liabilities) resulting from the transfer of reserves.

It remains to be noted how far the shrinkage in bank credit and in money of bank credit origin interfered with the maintenance of an adequate total money supply.<sup>5</sup> Such tests of the adequacy of the money supply are admittedly hard to apply. The level of interest rates, in a money market as imperfect as the Cuban, does not provide a very useful indication, since it is largely a matter of convention. Comparison of changes in the money supply with an index of business conditions like-

<sup>4</sup> The exclusion of time and savings deposits from the statistical concept of money is somewhat arbitrary, of course, and subject to the familiar doubts expressed by many writers on this topic. Particularly in a country like Cuba, where many savings accounts are operated by their holders almost like checking accounts, the assumption that the turnover of time deposits is sufficiently slow to deprive them of monetary characteristics requires considerable qualifications.

<sup>5</sup> While the term "adequate money supply" is somewhat vague, its use seems defensible in a country where the volume of "speculative" balances ( $L_2$  in Keynesian terminology) is normally small.

wise gives no clear picture, because business conditions themselves are in part dependent upon the money supply. The movement of prices could serve as an index of inflationary or deflationary pressure exerted by the money supply only if such fluctuations could be observed in the absence of disturbances from abroad, since the latter would carry more weight than domestic factors in an export economy like the Cuban. The state of the balance of payments likewise gives no indication, since it is governed primarily by external factors. Some indication, however, as to Cuban monetary requirements can perhaps be derived from the value of exports and from the computed value of the sugar crop, a closely related variable. Both reflect the monetary requirements of a major sector of the Cuban economy, which also happens to be the chief user of bank credit. These figures, moreover, are not significantly affected by the money supply itself, since the value of exports is determined mainly by other factors. Table 10 accordingly cor-

TABLE 10  
BANK LOANS, MONEY SUPPLY, AND VARIOUS BUSINESS INDEXES  
FOR SELECTED YEARS  
(In millions of dollars/pesos)

|      | Bank<br>Loans | Money<br>Supply | Money Supply<br>of Bank Credit<br>Origin | Exports            | Crop<br>Value <sup>a</sup> | Clearings        |
|------|---------------|-----------------|------------------------------------------|--------------------|----------------------------|------------------|
| 1920 | 285.9         | . <sup>b</sup>  | . <sup>b</sup>                           | 794.0              | 999.9                      | ... <sup>c</sup> |
| 1926 | 227.8         | 260.6           | . <sup>b</sup>                           | 301.7              | 245.4                      | 914.6            |
| 1930 | 163.6         | 160.9           | 110.1                                    | 167.4              | 128.7                      | 750.0            |
| 1932 | 112.4         | 110.1           | 83.3                                     | 80.7               | 41.4                       | 250.3            |
| 1937 | 69.2          | 143.5           | 28.6                                     | 186.1              | 117.2                      | 676.2            |
| 1940 | 67.1          | 161.3           | 40.7                                     | 127.3              | 84.7                       | 708.3            |
| 1944 | 88.0          | 551.9           | 23.0                                     | 427.1              | 230.6                      | 1,280.7          |
| 1945 | 110.7         | 667.9           | 25.5                                     | 409.9              | 227.2                      | 1,407.7          |
| 1946 | 161.8         | 782.1           | 59.5                                     | 475.9 <sup>d</sup> | 305.4                      | 1,840.2          |
| 1947 | 174.4         | 938.7           | 59.5                                     | 746.6 <sup>d</sup> | 610.4                      | 2,321.9          |

<sup>a</sup> Computed value of raw sugar only, not based on actual sales

<sup>b</sup> Not available

<sup>c</sup> Clearing house not yet established.

<sup>d</sup> These export figures of the Dirección General de Estadística differ from those used in estimating the balance of payments because of subsequent adjustments.

relates the money supply and related factors with exports and crop values for selected years.

From these figures it will be seen that between 1926 and 1937 the money supply fell by 44.9 per cent, against a reduction of 52.3 per cent in crop values and 38.3 per cent in exports. If the same comparison is made with the year 1930 as a base, the decline in the money supply is only 10.8 per cent, against a drop of 8.9 per cent for crop values and an 11.7 per cent rise for exports. These figures do not seem to indicate a significant over-all stringency in the money supply. The rise in the money supply from 1932 to 1937 is rather small in relation to that of the other variables,<sup>6</sup> which might be taken to signify that the degree of monetary expansion was inadequate to the needs of recovery. To some extent this may have been the case, but it must be observed that the balance of payments during that period was only moderately active and that a pronounced increase in the money supply might have turned it against Cuba. Such a reversal, during a period of cyclical upswing, would have been distinctly abnormal and undesirable for an export economy.

So far as estimates of this very broad character can go, they seem to indicate that while the money supply may have been somewhat smaller during the middle thirties than would have been desirable, the shortage was not significant. The contraction in bank credit was adequately, or almost adequately, offset by expansionary factors, and there is little warrant for suggesting that this contraction exerted a strong deflationary effect in an over-all sense.

#### B. DISTRIBUTION OF CREDIT

The tentative conclusion that the sharp contraction of bank credit during the thirties was largely compensated for by other factors and hence not significantly deflationary in an over-all sense, however, does not indicate how far the distribution of bank credit among different sectors of the economy was adequate to their needs. To this question, relating to the qualita-

<sup>6</sup> Particularly in view of the growing internal diversification of the Cuban economy during this period, which is not reflected in exports or sugar crop values.

TABLE 11

## BANK LOANS ACCORDING TO INDUSTRIES AND TYPES OF CREDIT, 1936-1947

| End of year | Loans to the Sugar Industry<br>(millions of dollars/pesos) |                  |                      |                               | Loans on Other Agricultural Products and on Livestock<br>(thousands of dollars/pesos) |        |      |                |        | Other Loans<br>(millions of dollars/pesos) |                        |                 |                     |                  |             |
|-------------|------------------------------------------------------------|------------------|----------------------|-------------------------------|---------------------------------------------------------------------------------------|--------|------|----------------|--------|--------------------------------------------|------------------------|-----------------|---------------------|------------------|-------------|
|             | Crop and production loans                                  | Secured by sugar | Secured by mortgages | Total loans to sugar industry | Tobacco                                                                               | Coffee | Rice | Other products | Cattle | Total                                      | Other industrial loans | Urban mortgages | Loans on securities | Commercial loans | Grand total |
|             |                                                            |                  |                      |                               |                                                                                       |        |      |                |        |                                            |                        |                 |                     |                  |             |
| 1936        | 19.0                                                       | 2.8              | 12.7                 | 35.6                          | 85                                                                                    | 28     |      | 124            | 150    | 387                                        | <sup>a</sup>           | 4.2             | 13.0                | 20.4             | 73.6        |
| 1937        | 13.7                                                       | 2.3              | 15.8                 | 31.8                          | 107                                                                                   | 86     | 65   | 192            | 171    | 623                                        | .4                     | 4.9             | 8.1                 | 23.3             | 69.2        |
| 1938        | 14.4                                                       | 4.9              | 14.5                 | 33.8                          | 397                                                                                   | 249    | 15   | 443            | 167    | 1,270                                      | .5                     | 3.2             | 6.9                 | 21.7             | 67.4        |
| 1939        | 12.2                                                       | 5.8              | 13.3                 | 31.2                          | 328                                                                                   | 33     |      | 156            | 151    | 669                                        | .3                     | 2.4             | 6.4                 | 28.1             | 69.1        |
| 1940        | 8.4                                                        | 9.3              | 11.3                 | 29.0                          | 304                                                                                   | 119    | 31   | 603            | 81     | 1,138                                      | .2                     | 2.0             | 4.3                 | 30.4             | 67.1        |
| 1941        | 9.5                                                        | 3.0              | 13.0                 | 25.5                          | 273                                                                                   | 308    |      | 284            | 83     | 948                                        | <sup>b</sup>           | 2.4             | 2.9                 | 28.6             | 60.4        |
| 1942        | 14.2                                                       | 3.8              | 11.1                 | 29.1                          | 208                                                                                   | 138    | 62   | 886            | 40     | 1,334                                      |                        | 1.6             | 8.0                 | 28.1             | 68.1        |
| 1943        | 13.4                                                       | 2.5              | 10.1                 | 26.0                          | 214                                                                                   | 331    | 154  | 2,228          | 35     | 2,962                                      | .                      | .9              | 6.5                 | 41.1             | 77.5        |
| 1944        | 15.3                                                       | 3.3              | 1.8                  | 20.4                          | 1,083                                                                                 | 95     | 230  | 3,618          | 7      | 5,033                                      |                        | 2.0             | 5.8                 | 54.7             | 88.0        |
| 1945        | 20.6                                                       | 4.1              | 1.8                  | 26.5                          | 865                                                                                   | 145    | 10   | 3,015          | 4      | 4,039                                      | .                      | 1.7             | 10.6                | 67.9             | 110.7       |
| 1946        | 28.6                                                       | 6.3              | 1.9                  | 36.8                          | 484                                                                                   | 502    | 43   | 4,938          | 4      | 5,971                                      | .                      | 2.0             | 12.8                | 104.3            | 161.8       |
| 1947        | 26.6                                                       | 5.5              | 1.3                  | 33.4                          | 1,876                                                                                 | 767    | 336  | 4,296          |        | 7,275                                      | ..                     | 2.0             | 10.5                | 121.2            | 174.4       |

<sup>a</sup> Not reported.<sup>b</sup> Included in commercial loans after June 1941Source. Dirección General de Estadística; *Circulación Monetaria y Movimiento Bancario*, 1936-1941, and Dirección General de Estadística, *Boletín Mensual de Estadísticas* (Havana), December 1947

tive rather than quantitative significance of bank credit, the answer clearly seems to be that distribution was very uneven and far from adequate.

Table 11 shows this distribution by industries from 1936 to 1947. During the first half of this period, the sugar industry on the average absorbed close to 50 per cent of total bank credit.<sup>7</sup> Commercial interests, mainly importers, took an average of 33 per cent, loans on securities and mortgages on urban real estate absorbed an average of 10 and 5 per cent respectively, and agricultural and industrial (other than sugar) credit amounted to 1 per cent each or less. During the war and post-war years, the financial needs of the sugar industry became smaller while commercial loans absorbed an increasing fraction of the total as a result of rising imports. At the end of 1947, almost 70 per cent of total bank credit was for commercial purposes.

In some cases these classifications probably are not entirely accurate; part of the loans listed as commercial may have been devoted to other purposes, and the destination of funds lent on securities is uncertain. Also, some of the mortgage loans to the sugar industry may have represented frozen assets rather than active credits. The deficiencies of the data, however, cannot greatly affect what is really the most striking feature of the distribution of bank credit: the very small amount going into agriculture (other than sugar cane) or into local industrial financing (other than sugar mills).

Cuba is, after all, an agricultural country, and even though agricultural cash crops, aside from cane, have not reached a very high state of development, the need for agricultural credit obviously is considerable. The same is true of Cuba's nascent industries; they are still at a very early stage of their development, and financially not very important, but their credit needs can hardly fail to be many times in excess of the 200,000 or 300,000 pesos they seem to have been getting during the late 1930's. It is possible, however, that the situation here was

<sup>7</sup> The year-end figures shown in Table 11 do not indicate the seasonal peak of sugar financing that normally occurs in the spring and frequently reaches amounts considerably higher than those prevailing during the rest of the year.

somewhat better than in agriculture, because some industrial borrowers may have been able to finance themselves through loans on securities and through credits listed as commercial. Cuban farmers are not likely to enjoy such opportunities, although a small amount of mortgage loans classed under sugar may actually have gone into other agricultural uses.

The desperate credit need of Cuban agriculturists is shown only too plainly in the manner in which at present they are forced to conduct their financing. Bank credit being unobtainable in most cases, the grower of tobacco, coffee, fruits, vegetables, beans, rice, and other products must obtain the funds necessary for producing his crop from local store keepers, produce merchants, and similar commercial sources. The latter can lend with some degree of safety, because almost invariably they are also the buyers of the crop, of which they can assure themselves by virtue of their position as creditors. In many cases they also sell materials and supplies to the farmer, for which he remains in debt. Their buying and selling and their financing give them almost complete economic control over their victims, and this, together with the inefficient and costly character of their operations and the risk element, finds expression in the high cost of agricultural credit. Although nominal interest rates are not necessarily high, and may in fact be zero, the interest implicit in the prices paid and charged is very burdensome. For tobacco growers, it has been estimated at roughly 40 per cent, for coffee producers at 33-40 per cent. For crops like beans it often is even higher.<sup>8</sup>

Even in the sugar industry conditions are far from satisfactory. Table II shows that the industry utilizes three types of credit. During the dead season, money is needed for the cultivation of cane, and perhaps for maintenance work at the mill. These loans usually take the form of crop liens (*créditos de refacción*), although sometimes they are covered by a mortgage on the property. During the crop season, the mill needs additional funds to pay for labor and cane. These loans are made on warehouse certificates covering the newly produced sugar (*créditos pignoratícios*), and it is customary to convert

<sup>8</sup> See Felipe Pazos y Roque, *La Banca* (Havana, 1944), pp. 19-20.



previously outstanding crop-lien loans into such secured credits as soon as the sugar becomes available. The total of loans outstanding usually reaches its high toward the end of the crop season. Thereafter loans are paid off progressively as sugar is sold.

Of the total cane produced, about 15 per cent normally has been administration cane, that is, cane grown by the mill; the remaining 85 per cent is grown by farmers (*colonos*) who own their land or rent it.<sup>9</sup> A substantial part of the dead-season demand for credit therefore emanates from the colonos. It is only the very largest colonos, however, with an annual output of over one million arrobas of cane (12,500 tons), who ordinarily have direct access to bank credit.<sup>10</sup> The remaining 98.4 per cent of the colonos, who produce less than this amount, normally have to do their financing through the mill to which they sell.<sup>11</sup> Some mills do this financing on a generous basis, by re-lending the funds obtained from their banking connection practically at cost. Frequently, however, the operation takes the form of a credit at the company store, or a store designated by the company, in which case the real interest cost often is said to go as high as 15-20 per cent.

The inadequate distribution of bank credit and the inability of wide sectors of the economy to obtain access to it are the fault, not so much of the individual banks, as of the one-sided nature of the banking system. Although the existing banks undoubtedly could broaden their operations considerably, they are not equipped to deal with the highly specialized credit problems presented by agricultural and small industrial borrowers. These ills could be remedied only by means of a broad program that would include (1) the creation of specialized credit institutions, (2) the establishment of storage and marketing facilities to help convert the poorer borrowers' assets into acceptable collateral, and (3) the education of the borrowers in order to convert them into morally and materially acceptable risks.

<sup>9</sup> Ramiro Guerra y Sánchez, *La Industria Azucarera de Cuba* (Havana, 1940), p. 100. The figures are those of the 1937 census.

<sup>10</sup> Pazos, *La Banca*, p. 17.

<sup>11</sup> Guerra, *La Industria Azucarera de Cuba*, p. 119.

Such measures would almost inevitably have to be of a governmental rather than a private character. The experience of most Latin American countries shows that only in rare cases can private enterprise meet the difficulties and shoulder the risks connected with the provision of adequate agricultural and industrial credit. While private efforts in this direction are by no means unknown, the practice of such institutions usually has been, perhaps unavoidably, to concentrate on the stronger risks and to leave those most in need of assistance uncared for.

In Cuba the creation of adequate private sources of agricultural and industrial credit meets with perhaps even greater obstacles than elsewhere in Latin America. The foreign banks are handicapped in this respect by their traditional commercial credit principles, the remote control to which they are subject, and the implications of their alien nationality. All banks in Cuba have suffered from adverse legislation, such as the moratoria and the legal tender law; and the violence of economic fluctuations has convinced most of them of the need for extreme caution. While some headway has been made during the war years in broadening existing credit facilities, an adequate supply of agricultural and industrial credit is not likely to be forthcoming unless the government is willing to shoulder some of the responsibility.<sup>12</sup>

### C. INTEREST RATES

The most notable feature of the rates charged by banks is their extreme diversity, in accordance with the type and quality of the risk. During the middle forties, rates on sugar warehouse certificates (*créditos pignoraticios*) ranged from 2½ to 5 per cent. On first-class commercial paper between 4 and 6 per cent was charged, but on lower-grade paper rates ran as high as 12 per cent. On crop loans (*créditos refaccionarios*) rates were from 8 to 10 per cent, with the alleged exception of certain American mills which were said to obtain such funds at 3 to 4 per cent.

<sup>12</sup> The creation of the Banco de los Colonos, to serve the credit needs of sugar-cane producers, is an example of both the potentialities and the limitations of private action in the agricultural credit field.

These rates are considerably lower than those prevailing ten and twenty years ago, although some of them are still very high from the American point of view. In the light of the conditions prevailing in other Latin American countries they are not exorbitant. Neither comparison, however, is entirely fair. One cannot discuss American and Cuban credit conditions on equal terms, but, on the other hand, one would expect Cuba to be somewhat more favorably placed than countries where large-scale industrial borrowers and highly efficient large banks are absent.

The rate structure reflects a curious mixture of monopolistic and competitive elements. For high-grade loans competition is very keen and rates are correspondingly low. Less desirable risks, which lack appeal for most of the foreign banks, are restricted to a much narrower circle of potential lenders. This fact, together with the high risk premium, forces up the rate. Borrowers still further out along the risk scale are altogether unable to secure bank accommodation and often find themselves exposed to the grosser forms of exploitation described above.

Worthy of note is the wide margin between some of the rates charged on loans and the interest that banks pay on deposits. In 1940 neither the American nor the Canadian banks paid interest on demand deposits, while domestic banks paid  $\frac{1}{4}$  to 1 per cent. On savings deposits American and Canadian banks paid  $\frac{1}{2}$  to 1 per cent, while domestic banks paid between  $\frac{1}{2}$  and 3 per cent. With respect to deposit rates, therefore, the foreign banks adhere to the practices of their home countries. The domestic banks, and particularly the smaller ones, find it necessary to pay more in order to attract deposits.

## 2. EXCHANGE POLICY

Before 1932, the Cuban banks were blessed with a freedom from foreign exchange problems very unusual in an export economy. The initiation of the silver policy in 1932, however, confronted the banks with a difficult internal exchange problem. They found themselves operating in two currencies, one of them at a fluctuating discount from the other, with considerable un-

certainty as to the true exchange denomination of some of their assets and with only a very inadequate market in which to cover their positions. While they continued to treat the dollar as the basic unit of account and the peso as a foreign currency — since the peso legally was regarded as being at par with the dollar, they could hardly have done otherwise — they found the peso gaining ground against the dollar and constantly broadening its own sphere. Finally, in 1939, they found themselves faced with a sudden substantial decline in the value of the peso, the possible extent of which they could not foresee.

Under these conditions, it is of interest to investigate how the banks handled their exchange positions and particularly whether and how far their operations influenced the peso rate. From the conservative banking viewpoint, it was to be expected that the banks would endeavor to eliminate exchange risks by maintaining a balanced position, that is, by keeping their peso assets equal to their peso liabilities, which automatically implied keeping also their dollar assets equal to their dollar liabilities.<sup>13</sup> The evidence presented below indicates that in times of crisis this policy was followed fairly strictly. On the other hand, the fluctuations in the exchange rate gave the banks an opportunity to make profits of a speculative character, and it will presently appear that they availed themselves of this possibility whenever the risk seemed small.

For a study of the banks' exchange operations from July 1936 to December 1942, the period holding the main interest, three sets of data are available, covering different parts of that period:<sup>14</sup> (1) the net peso position of the banking system; (2) the net peso position minus certain unspecified assets, a less purified version of the first series; and (3) the peso purchases and sales of the banks, cumulated so as to show the trend of their peso position (see Table 12).

<sup>13</sup> A long or short peso position is simply the reciprocal of a short or long dollar position, provided capital funds are regarded as liabilities and provided capital funds are regarded as liabilities and provided there are no other exchange positions. The normal practice apparently was to regard capital funds as part of *dollar* liabilities, in order to protect this investment against exchange depreciation.

<sup>14</sup> The action of the banks immediately following the first silver issue in 1932 was commented on in Chapter IV. Unfortunately, statistical data for that period are not available.

TABLE 12

THE BANKS' PESO POSITION AND RELATED ITEMS, 1936-1942  
(In thousands of pesos)

| <i>End of</i> | <i>Net Peso Position<br/>Minus</i>   |                                     | <i>Cumulative Peso<br/>Purchases<sup>c</sup></i> | <i>Peso Rate<sup>d</sup></i> |
|---------------|--------------------------------------|-------------------------------------|--------------------------------------------------|------------------------------|
|               | <i>Net Peso Position<sup>a</sup></i> | <i>Net Other Assets<sup>b</sup></i> |                                                  |                              |
| <i>1936</i>   | (1)                                  | (2)                                 | (3)                                              |                              |
| July          |                                      |                                     | +390                                             | 98.62                        |
| Aug.          |                                      |                                     | +396                                             | 98.25                        |
| Sept.         |                                      |                                     | +1,058                                           | 98.06                        |
| Oct.          |                                      |                                     | +4,313                                           | 98.12                        |
| Nov.          |                                      |                                     | +5,257                                           | 98.62                        |
| Dec.          |                                      |                                     | +5,890                                           | 99.00                        |
| <i>1937</i>   |                                      |                                     |                                                  |                              |
| Jan.          |                                      |                                     | +4,767                                           | 98.69                        |
| Feb.          |                                      |                                     | +2,177                                           | 99.25                        |
| Mar.          |                                      |                                     | +3,541                                           | 99.44                        |
| Apr.          |                                      |                                     | -190                                             | 98.75                        |
| May           |                                      |                                     | -2,643                                           | 98.69                        |
| June          |                                      |                                     | -968                                             | 98.87                        |
| July          |                                      | -9,763                              | -481                                             | 98.87                        |
| Aug.          |                                      | -9,562                              | -699                                             | 99.00                        |
| Sept.         |                                      | -7,962                              | +1,050                                           | 99.25                        |
| Oct.          |                                      | -5,931                              | +2,142                                           | 99.37                        |
| Nov.          |                                      | -2,866                              | +3,563                                           | 99.37                        |
| Dec.          |                                      | +4,123                              | +3,513                                           | 99.25                        |
| <i>1938</i>   |                                      |                                     |                                                  |                              |
| Jan.          |                                      | -2,014                              | +3,260                                           | 99.50                        |
| Feb.          |                                      | -9,581                              | -207                                             | 99.50                        |
| Mar.          |                                      | -8,447                              | -3,221                                           | 99.50                        |
| Apr.          |                                      | -10,404                             | -5,035                                           | 99.37                        |
| May           |                                      | -7,219                              | -2,728                                           | 98.12                        |
| June          |                                      | -5,865                              | -1,087                                           | 97.44                        |
| July          |                                      | -3,717                              | -396                                             | 97.62                        |
| Aug.          |                                      | -4,281                              | +263                                             | 97.42                        |
| Sept.         |                                      | +971                                | -36                                              | 96.75                        |
| Oct.          |                                      | -1,869                              | +179                                             | 96.64                        |
| Nov.          |                                      | +711                                | +1,219                                           | 97.17                        |
| Dec.          |                                      | +3,181                              | +2,589                                           | 98.05                        |

TABLE 12 (Continued)

| <i>End of</i> | <i>Net Peso Position<sup>a</sup></i> | <i>Net Peso Position<br/>Minus<br/>Net Other Assets<sup>b</sup></i> | <i>Cumulative Peso<br/>Purchases<sup>c</sup></i> | <i>Peso Rate<sup>d</sup></i> |
|---------------|--------------------------------------|---------------------------------------------------------------------|--------------------------------------------------|------------------------------|
| <i>1939</i>   | (1)                                  | (2)                                                                 | (3)                                              |                              |
| Jan.          |                                      | +1,636                                                              | +1,461                                           | 97.56                        |
| Feb.          |                                      | -3,008                                                              | -954                                             | 97.52                        |
| Mar.          |                                      | -5,445                                                              | -4,123                                           | 96.34                        |
| Apr.          |                                      | -5,713                                                              | -4,425                                           | 96.37                        |
| May           |                                      | -5,741                                                              | -4,483                                           | 95.12                        |
| June          | +501                                 | -4,720                                                              | -4,310                                           | 93.75                        |
| July          | +723                                 |                                                                     | -4,292                                           | 90.86                        |
| Aug.          | +253                                 |                                                                     | -4,452                                           | 88.52                        |
| Sept.         | +400                                 |                                                                     | -4,577                                           | 90.87                        |
| Oct.          | +651                                 |                                                                     | -4,025                                           | 90.55                        |
| Nov.          | +298                                 |                                                                     | -3,603                                           | 87.16                        |
| Dec.          | +222                                 |                                                                     | -3,578                                           | 88.08                        |
| <i>1940</i>   |                                      |                                                                     |                                                  |                              |
| Jan.          | +494                                 |                                                                     | -3,386                                           | 89.80                        |
| Feb.          | -96                                  |                                                                     | -4,842                                           | 91.84                        |
| Mar.          | -643                                 |                                                                     | -4,442                                           | 89.53                        |
| Apr.          | +90                                  |                                                                     | -3,871                                           | 88.27                        |
| May           | +644                                 |                                                                     | -2,893                                           | 89.75                        |
| June          | +928                                 |                                                                     | -1,734                                           | 89.80                        |
| July          | +1,217                               |                                                                     | -1,756                                           | 90.03                        |
| Aug.          | +919                                 |                                                                     | -1,308                                           | 88.53                        |
| Sept.         | +1,069                               |                                                                     | -58                                              | 90.12                        |
| Oct.          | +1,283                               |                                                                     | -86                                              | 91.31                        |
| Nov.          | +2,011                               |                                                                     | +62                                              | 91.33                        |
| Dec.          | +1,838                               |                                                                     | +857                                             | 91.34                        |
| <i>1941</i>   |                                      |                                                                     |                                                  |                              |
| Jan.          | +2,334                               |                                                                     | +419                                             | 91.64                        |
| Feb.          | +714                                 |                                                                     | -182                                             | 92.84                        |
| Mar.          | +320                                 |                                                                     | -475                                             | 94.41                        |
| Apr.          | +880                                 |                                                                     | -52                                              | 95.53                        |
| May           | +662                                 |                                                                     | -434                                             | 97.37                        |
| June          | +869                                 |                                                                     | -730                                             | 98.66                        |
| July          | +118                                 |                                                                     |                                                  | 98.70                        |

TABLE 12 (Continued)

| <i>End of</i> | <i>Net Peso Position<sup>a</sup></i> | <i>Net Peso Position<br/>Minus<br/>Net Other Assets<sup>b</sup></i> | <i>Cumulative Peso<br/>Purchases<sup>c</sup></i> | <i>Peso Rate<sup>d</sup></i> |
|---------------|--------------------------------------|---------------------------------------------------------------------|--------------------------------------------------|------------------------------|
|               | (1)                                  | (2)                                                                 | (3)                                              |                              |
| Aug.          | -396                                 |                                                                     |                                                  | 98.89                        |
| Sept.         | +270                                 |                                                                     |                                                  | 99.50                        |
| Oct.          | +563                                 |                                                                     |                                                  | 99.81                        |
| Nov.          | +1,206                               |                                                                     |                                                  | 99.86                        |
| Dec.          | +1,617                               |                                                                     |                                                  | 99.94                        |
| 1942          |                                      |                                                                     |                                                  |                              |
| Jan.          | +3,828                               |                                                                     |                                                  | 100.00                       |
| Feb.          | +2,361                               |                                                                     |                                                  | 100.39                       |
| Mar.          | -851                                 |                                                                     |                                                  | 100.13                       |
| Apr.          | -2,226                               |                                                                     |                                                  | 100.17                       |
| May           | -2,787                               |                                                                     |                                                  | 100.16                       |
| June          | -1,274                               |                                                                     |                                                  | 100.00                       |
| July          | -1,064                               |                                                                     |                                                  | 100.10                       |
| Aug.          | -1,505                               |                                                                     |                                                  | 100.10                       |
| Sept.         | -1,412                               |                                                                     |                                                  | 100.00                       |
| Oct.          | -1,092                               |                                                                     |                                                  | 100.00                       |
| Nov.          | -730                                 |                                                                     |                                                  | 100.00                       |
| Dec.          | -844                                 |                                                                     |                                                  | 100.00                       |

<sup>a</sup> Series 1, "Net Peso Position" of the reporting banks, indicating the excess (+ or -) of peso assets over peso liabilities, is available only since June 1939. This is the only series which may, within certain limits, be regarded as conclusive evidence as to the exchange position of the banking system—that is, the extent to which the banks as a group were long or short of pesos at any given time.

<sup>b</sup> Series 2 is a less purified version of the preceding series and covers the earlier period July 1937-June 1939. In this series, the "net peso position" is inextricably mixed with a residual item, the exchange denomination of which is not known. The latter item is the difference (+ or -) between those assets and liabilities for which the currency is not indicated in the consolidated statement of the reporting banks. An exact determination of the exchange position of the banks is not possible on the basis of these data, but, on the reasonable assumption that the "net other assets" were free from extreme fluctuations (which was true after June 1939 when the exact data became available), changes in the "net peso position minus net other assets" may be taken as a rough index of changes in the "net position."

<sup>c</sup> Series 3 is based on monthly purchases and sales of pesos by the banks for the period July 1936-June 1941. These figures purportedly comprise all the exchange transactions of Cuban banks and should therefore give an accurate picture of changes in their exchange position, although not, of course, of the exact position at any given time. There is reason, however, to doubt the accuracy of these figures, since they are not in conformity with the changes in the net position as indicated by series 1, during the two years from June 1939 to July 1941 for which the two series overlap, and also because the movement of the series warrants the suspicion of a cumulative error. The series must be used with caution, but it is probably quite reliable as an index of changes in the direction in which the net position was moving.

<sup>d</sup> Monthly average.

From these three series it is possible to obtain a fairly good picture of the exchange policy followed by the banks from the summer of 1936.<sup>15</sup> Broadly speaking, this policy was to go long of pesos when the peso exchange rate was low, and to sell out and perhaps take a short position when the rate was high. The peso usually was strong during the early part of the year, and tended to weaken in the latter half. These seasonal fluctuations would have been much more marked if the banks had persistently maintained a balanced exchange position. Ordinarily the risks involved in an unstable exchange would have called for just such a neutral policy, but in the Cuban case there was little danger that the peso might depreciate permanently, as long as enough dollars remained in circulation. By going short of pesos during the period of active demand — that is, during the first three or four months of the year — and building up a long position later, the banks not only were able to smooth out the seasonal movement of the exchange rate, but also to make a fair profit.

The extent to which the banks followed this policy of being alternately short and long during the period 1936–1938 is indicated in Table 12 by series 3. It shows that during the first three or four months of each of these years a rapid reduction in the peso position took place and that this was reversed during the latter half of the year. A comparison of the rates at which net sales and net purchases were made reveals that the operation usually was profitable. Pérez and Pazos estimate annual profits from this source at 50,000 to 100,000 pesos.<sup>16</sup>

Considerable interest attaches to exchange operations in 1939, in view of the sharp break in the exchange that occurred during that year. During the first five months of 1939 the banks reduced their peso position by 7,072,000 pesos, according to series 3. This certainly was a large block of exchange to be thrown upon a weakening market. It will be observed, however, that practically all the selling was done during January, Febru-

<sup>15</sup> The data represent the operations of the banking system as a whole, and are not necessarily characteristic of the operations of each single institution. Since the net position usually is quite small it may well have been the result of the operations of only one or two of the large banks.

<sup>16</sup> *El Problema Monetario*, p. 67.



ary, and March, and that during this time the peso dropped only 1.22 points (from 97.56 to 96.34). The big break came between May and July, when the banks apparently had stabilized their position.

Moreover, the initial figure in series 1, relating to June 1939, shows that the banks at that time still were long 501,000 pesos, in spite of the heavy sales that preceded. In other words, the banks during the first half of 1939 sold out their long position, but seem to have refrained from going substantially short. The evidence of series 2 serves to confirm this.<sup>17</sup> It will be noted that the figures shown are -5,741,000 for May 1939, and -4,720,000 for June, and that the net peso position for the latter months (the first month for which it is available) is +501,000. Since "net other assets," which cannot be separated out for May, probably did not change very much between May and June, the net peso position in May cannot have been short by much more than 500,000 pesos.

If the data may be accepted as approximately correct, the conclusions to be drawn are as follows: The banks did indeed contribute to the decline of 1939 by substantial net sales of pesos. These sales, however, were made before the decline had become very serious, and did not fall into the critical period. Moreover, the banks were not selling short substantially, which under the circumstances might have been regarded as reprehensible, but were merely liquidating a long position.<sup>18</sup> By previously taking this long position they actually had lent considerable support to the peso. It is not unlikely that in liquidating the position minor losses were suffered, since rates as low as 96.34 had not prevailed previously.

These considerations should dispose of the charge made in the contemporary press that the banks were to blame for the drop in the peso, or that their policy was deliberately aimed at undermining the Cuban currency. Their policy was precisely what it should have been under the circumstances: when the exchange

<sup>17</sup> This series also lends weight to the belief that in previous years the banks had gone short quite substantially. Its low point in 1939 was only -5,713,000 pesos, whereas in 1937 and 1938 lows of -9,763,000 and -10,404,000, respectively, had been reached.

<sup>18</sup> A few individual banks may of course have been taking a short position.

became seriously unstable, they liquidated their long position and endeavored to maintain a balanced one, leaving the exchange rate to the forces of the market and to the ingenuity of the government.

From June 1939 to May 1940 the banks maintained a fairly balanced position, with a slight bias toward the long side. During this period the peso fluctuated around the 90.00 level. In June 1940 they once more began to accumulate pesos, their long position reaching a maximum of 2,334,000 in January 1941. This operation proved quite profitable, within the limits of the rather small amounts involved. In September 1940 the peso began to recover and continued to rise almost uninterruptedly until it reached par in December 1941. During the greater part of this rise, which occurred during the first eight months of 1941, the banks were reducing their position, but they remained on the long side except for one brief period. From September 1941 until January 1942 they once more built up a substantial long position, which they promptly sold out during the following crop season. The relative magnitude of the long and short positions taken in 1942, which considerably exceeded those of 1940 and 1941, seems to indicate that with the reestablishment of parity the banks no longer felt it necessary to observe the extreme caution that had characterized their operations during the period of instability.

There is little evidence that the operations of the banks affected the exchange rate during the period 1940-1942, or that these operations were in any way responsible for the peso's return to parity. Perhaps there was some minor influence of this kind, but it must have been quite small, since the banks' operations were not on a large scale. The rise of the peso lagged so far behind the beginning of peso accumulation by the banks that one can hardly ascribe much influence to the latter. During most of 1941 the peso rose although the banks were net sellers. The fact that the premium which appeared in February 1942 became less pronounced in March, April, and May, can to some extent perhaps be ascribed to the banks' action in liquidating their long position of 3,828,000 pesos and going short to the extent of 2,787,000.

### 3. CASH RESERVES AND BALANCES ABROAD

An important aspect of the policies pursued by the Cuban banks is reflected in their reserve position. This position consists of two major components: cash holdings in Cuba and balances with head offices or foreign correspondents.

#### A. CASH RESERVES

The Cuban Commercial Code of 1886 contains a clause — which prior to 1938 was not too widely known and even less widely observed — requiring banks to carry cash reserves equal to 25 per cent of their total deposits. For a country without a lender of last resort, this reserve requirement is by no means high. The repeated runs to which Cuban banks have been subjected seemed to point to the desirability of reserves well in excess of 25 per cent; after the crash of 1920, in fact, some foreign bankers believed that 50 per cent was more nearly the required amount. Table 13 indicates that from 1921 to 1923 reserves approximating 40 per cent or more were carried by the limited number of banks that reported during that period.<sup>19</sup>

The establishment of the agencies of the Federal Reserve Banks of Boston and Atlanta in 1923 (their functions were carried on by the Atlanta agency alone after 1926) brought a considerable change in the picture. The wire service maintained by these agencies gave the foreign banks instantaneous access to the reserves of their head offices, on which they previously could not rely because the delay in shipping currency to Havana might have been dangerous in case of a run. For the domestic banks the improvement was not nearly so great, but they, too, gained to the extent that liquid funds and credit facilities abroad became available as secondary reserves.<sup>20</sup>

During the course of the 1920's the banks as a group lowered their reserves very considerably, allowing them to drop as low as 10 per cent in 1928. No attempt apparently was made on the part of the authorities to call to the banks' attention the reserve

<sup>19</sup> The accuracy of these figures is somewhat uncertain; it is possible that they exaggerate the proportion of reserves

<sup>20</sup> Funds abroad were not, of course, reserves within the meaning of the Commercial Code.

TABLE 13  
BANK RESERVES AND BALANCES ABROAD, 1921-1947  
(In millions of dollars/pesos)

| End of Year | Cash            | Total Deposits | Reserve Ratio (cash deposits) | Assets Abroad | Liabilities Abroad | Net Balances Abroad |
|-------------|-----------------|----------------|-------------------------------|---------------|--------------------|---------------------|
| 1921        | 42.7            | 80.0           | 53.4                          |               |                    |                     |
| 1922        | 44.5            | 104.8          | 42.5                          |               |                    |                     |
| 1923        | 54.3            | 136.7          | 39.7                          |               |                    |                     |
| 1924        | 52.8            | 157.6          | 33.5                          |               |                    |                     |
| 1925        | .. <sup>a</sup> | 173.6          | <sup>a</sup>                  |               |                    |                     |
| 1926        | 28.5            | 167.6          | 17.0                          |               |                    |                     |
| 1927        | 25.7            | 239.4          | 10.7                          |               |                    |                     |
| 1928        | 24.2            | 242.4          | 10.0                          |               |                    |                     |
| 1929        | 22.7            | 222.4          | 10.2                          |               |                    |                     |
| 1930        | 19.6            | 144.7          | 13.5                          | 4.6           | 37.4               | -32.8               |
| 1931        | 14.4            | 111.0          | 13.0                          | 8.8           | 50.1               | -41.3               |
| 1932        | 15.0            | 103.3          | 14.5                          | 10.4          | 40.1               | -29.7               |
| 1933        | 14.6            | 88.0           | 16.6                          | 8.8           | 41.8               | -33.0               |
| 1934        | 21.8            | 98.3           | 22.2                          | 5.7           | 31.3               | -25.6               |
| 1935        | 25.3            | 109.4          | 23.1                          | 30.1          | 39.4               | -9.3                |
| 1936        | 32.0            | 130.1          | 24.6                          | 32.3          | 8.5                | 23.8                |
| 1937        | 34.0            | 138.7          | 24.5                          | 20.0          | 1.6                | 18.4                |
| 1938        | 48.1            | 139.0          | 34.6                          | 8.5           | 3.3                | 5.2                 |
| 1939        | 50.5            | 128.1          | 39.4                          | 2.6           | 10.4               | -7.8                |
| 1940        | 41.3            | 128.8          | 32.1                          | 8.2           | 7.3                | .9                  |
| 1941        | 40.7            | 139.2          | 29.2                          | 26.4          | 2.8                | 23.6                |
| 1942        | 83.9            | 187.0          | 44.9                          | 72.5          | 53.4               | 19.1                |
| 1943        | 138.4           | 261.2          | 53.0                          | 44.0          | 13.6               | 30.4                |
| 1944        | 198.1           | 370.9          | 53.4                          | 100.9         | 33.8               | 67.1                |
| 1945        | 229.5           | 432.8          | 53.0                          | 98.4          | 23.6               | 74.8                |
| 1946        | 225.2           | 502.5          | 44.8                          | 108.6         | 12.3               | 96.3                |
| 1947        | 269.3           | 586.2          | 45.9                          | 187.0         | 75.4               | 111.6               |

<sup>a</sup> Not available

Source: Data supplied by Cuban Treasury. The banking statistics underlying these figures are less comprehensive than those used for the analysis of the money supply (Tables 1, 4, and 8) and the two sets of data therefore are not fully comparable.

requirements of the Commercial Code. It seems clear that during this period excessive reliance was placed upon Federal Reserve facilities. In order to bring effective reserves in Cuba — inclusive of agency holdings — to the level of 25 per cent, the Atlanta agency ought to have carried at least 40 million dollars

in unissued notes. To meet comfortably an emergency such as the run in 1926, an even higher amount would have been required. Actually, the agency never seems to have carried more than 23 million dollars of currency. Whether or not the currency reserves of the agency were known to the commercial banks is not quite clear; after the events of 1926 they certainly understood that these holdings were limited. The relatively small size of the agency's reserves occasioned a certain amount of apprehension, but the improvement in air communications gradually brought the currency supplies at the Atlanta head office and at the Jacksonville branch within easy reach.

During the 1930's the reserve ratio of the Cuban banks steadily increased. In part this was due to the accumulation of funds that could find no outlet in Cuba, and in part to the policy of most banks of carrying rather substantial reserves against peso liabilities. This policy was motivated by the fear that a drop in the peso might produce dangerous runs, against which dollar reserves alone would have been poor protection.<sup>21</sup> As a commentary on the potential usefulness of a central bank as a lender of last resort, the banks' peso reserve policy is not uninteresting. With the growth in the peso circulation, reserves increased steadily, until toward the middle of 1938 they approached the legal level of 25 per cent. For this reason the government's sudden insistence upon these requirements, as expressed in the law of June 28, 1938, did not cause great inconvenience to most of the banks; the required level had just been reached in the natural course of events and was subsequently exceeded by a wide margin, as shown in Table 14. For the same reason, and also because of the decline in the importance of the dollar, the closing of the Federal Reserve Agency in September 1938 did not create a major problem for the banks.

#### B. BALANCES ABROAD

The balances that Cuban banks maintained at various times with their head offices in the United States or with foreign correspondents did not form part of their legal reserves. They did,

<sup>21</sup> Dollars could of course have been employed to meet withdrawals, but only at a loss to the banks.

TABLE 14  
PESO AND DOLLAR DEPOSITS AND RESERVES, JULY 1937-NOVEMBER 1939, BY MONTHS  
(In millions)

|       | Peso<br>Deposits | Peso<br>Reserves | Peso<br>Reserve Ratio<br>(per cent) | Dollar<br>Deposits | Dollar<br>Reserves | Dollar<br>Reserve Ratio<br>(per cent) | Total<br>Deposits | Total<br>Reserves | Total<br>Reserve Ratio<br>(per cent) |
|-------|------------------|------------------|-------------------------------------|--------------------|--------------------|---------------------------------------|-------------------|-------------------|--------------------------------------|
| 1937  |                  |                  |                                     |                    |                    |                                       |                   |                   |                                      |
| July  | 48.2             | 14.9             | 30.9                                | 101.2              | 12.6               | 12.4                                  | 149.4             | 27.5              | 18.4                                 |
| Aug.  | 48.8             | 15.8             | 32.4                                | 100.9              | 12.8               | 12.7                                  | 149.7             | 28.6              | 19.1                                 |
| Sept. | 48.9             | 17.2             | 35.2                                | 98.8               | 12.2               | 12.2                                  | 147.7             | 29.4              | 19.9                                 |
| Oct.  | 46.4             | 16.9             | 36.4                                | 96.0               | 12.5               | 13.0                                  | 142.4             | 29.4              | 20.6                                 |
| Nov.  | 45.7             | 19.4             | 42.5                                | 95.6               | 12.4               | 13.0                                  | 141.3             | 31.8              | 22.5                                 |
| Dec.  | 46.4             | 21.0             | 45.3                                | 91.8               | 12.6               | 13.7                                  | 138.2             | 33.6              | 24.3                                 |
| 1938  |                  |                  |                                     |                    |                    |                                       |                   |                   |                                      |
| Jan.  | 48.5             | 22.1             | 45.6                                | 92.1               | 12.2               | 13.1                                  | 140.6             | 34.3              | 24.4                                 |
| Feb.  | 52.7             | 17.1             | 32.4                                | 92.3               | 12.0               | 13.0                                  | 145.0             | 29.1              | 20.1                                 |
| Mar.  | 50.8             | 15.6             | 30.7                                | 97.1               | 12.5               | 12.9                                  | 147.9             | 28.1              | 19.0                                 |
| Apr.  | 53.4             | 16.4             | 30.7                                | 96.9               | 12.7               | 13.1                                  | 150.3             | 29.1              | 19.4                                 |
| May   | 52.8             | 19.3             | 36.6                                | 97.0               | 12.7               | 13.1                                  | 149.8             | 32.0              | 21.4                                 |
| June  | 53.6             | 21.6             | 40.3                                | 92.7               | 15.1               | 16.3                                  | 146.3             | 36.7              | 25.1                                 |
| July  | 52.0             | 23.5             | 45.2                                | 90.6               | 15.3               | 16.9                                  | 142.6             | 38.8              | 27.2                                 |
| Aug.  | 53.1             | 25.1             | 47.3                                | 89.2               | 14.1               | 15.8                                  | 142.3             | 39.2              | 27.5                                 |
| Sept. | 54.1             | 26.0             | 48.1                                | 88.8               | 14.2               | 16.0                                  | 142.9             | 40.2              | 28.1                                 |
| Oct.  | 54.6             | 27.5             | 50.4                                | 86.7               | 15.2               | 17.5                                  | 140.3             | 42.7              | 30.4                                 |
| Nov.  | 56.2             | 31.4             | 55.9                                | 83.0               | 14.5               | 17.5                                  | 139.2             | 45.9              | 33.0                                 |
| Dec.  | 56.9             | 32.5             | 57.1                                | 81.7               | 15.2               | 18.6                                  | 138.6             | 47.7              | 34.4                                 |
| 1939  |                  |                  |                                     |                    |                    |                                       |                   |                   |                                      |
| Jan.  | 59.0             | 34.1             | 57.8                                | 79.4               | 18.1               | 22.8                                  | 138.4             | 52.2              | 37.7                                 |
| Feb.  | 63.1             | 32.1             | 50.9                                | 70.5               | 18.0               | 22.6                                  | 142.6             | 50.1              | 35.1                                 |
| Mar.  | 63.4             | 28.6             | 45.1                                | 81.2               | 18.1               | 22.3                                  | 144.6             | 46.7              | 32.3                                 |
| Apr.  | 63.6             | 28.6             | 45.0                                | 78.9               | 16.7               | 21.2                                  | 142.5             | 45.3              | 31.8                                 |
| May   | 62.1             | 28.6             | 46.1                                | 78.3               | 16.5               | 21.1                                  | 140.4             | 45.1              | 32.1                                 |
| June  | 62.0             | 30.0             | 48.4                                | 76.3               | 15.1               | 19.8                                  | 138.3             | 45.1              | 32.6                                 |
| July  | 64.0             | 32.5             | 50.8                                | 63.2               | 14.5               | 22.9                                  | 137.2             | 47.0              | 36.9                                 |
| Aug.  | 66.4             | 35.4             | 53.4                                | 60.1               | 12.9               | 21.5                                  | 126.5             | 48.3              | 38.2                                 |
| Sept. | 68.3             | 36.8             | 53.9                                | 59.5               | 12.5               | 21.0                                  | 127.8             | 49.3              | 38.6                                 |
| Oct.  | 68.7             | 37.0             | 53.9                                | 57.0               | 12.7               | 22.3                                  | 125.7             | 49.7              | 39.5                                 |
| Nov.  | 70.0             | 37.6             | 53.7                                | 56.2               | 13.2               | 23.5                                  | 120.2             | 50.8              | 40.3                                 |

however, play an important role in the Cuban monetary picture. Data on the volume of these balances are available only since 1930 and are shown in Table 13. It is evident from these figures that during the first half of the thirties, the banks as a group were heavily in debt to head offices and foreign correspondents, although some individual banks may have had credit balances. The maximum net indebtedness was that recorded in 1931, amounting to 41.3 million dollars.<sup>22</sup> These debit balances resulted from the use of head-office funds for loans in Cuba. The National City Bank of New York in Cuba, according to its statement of June 30, 1920, was employing 33.7 million dollars of head-office funds in Cuba at that time (Table 2). Of the funds thus brought into Cuba by the banks, probably a good part had become frozen in illiquid loans.

It was not before 1936 that the banks as a group succeeded in working off their foreign indebtedness. This was accomplished through collection of old loans, through write-offs of uncollectible claims, and through the increase in deposits resulting from the active balance of payments. Thereafter the banks accumulated a net credit balance which reached a high of 23.8 million in 1936, only to be drawn down again owing to the outflow of funds in 1938 and 1939. A small debit balance appeared again in 1939 and was intensified after the outbreak of the war by a mild run upon the Canadian branches, which met the run by drawing upon their head offices. The sharply active turn in the balance of payments during the war once more reversed this trend, and the banks again began to build up large credit balances. These undoubtedly would have far exceeded the level of 111.6 millions attained in 1947, had not the tax of 0.15 per cent monthly forced the banks to transfer a large part of their funds to Cuba in the form of currency. The American branches enjoyed certain advantages in being able to maintain tax-free

<sup>22</sup> Various Cuban sources are available for the computation of these data. The sources differ widely as to the gross debit and credit balances existing at any one time, but agree fairly well as to the *net* position. The discrepancies in the gross balances no doubt result from the practice of some of the banks of carrying several accounts with their respective head offices, some of which may have shown credit, others debt balances.

abroad the funds derived from payments by the Commodity Credit Corporation for its sugar purchases.

On their credit balances abroad the banks, or their head offices, probably were able to earn a moderate rate of return. It is clear, however, that rates in New York were much less remunerative than in Cuba and that the holding of funds abroad was advantageous only if no outlet could be found for them in Cuba. This fact goes some way to answer the complaint that the foreign banks, by holding part of their funds outside the country, were depriving the Cuban economy of resources that rightfully should have been invested locally. The chances are that if these funds had been brought to Cuba in the form of currency, the banks would have kept them idle in their vaults.

It is true, of course, that the lending policy of the banks was highly conservative and that this made their foreign balances relatively larger. But wartime experience has confirmed what seemed clear *a priori* — that the foreign banks' lending policy is influenced very little by the existence of excess reserves. The conversion of foreign balances into cash in Cuba, made necessary by the 0.15 per cent tax, greatly raised excess reserves but seems to have affected very little the volume of lending.

Neither is it appropriate to regard the banks' balances abroad as a manifestation of capital flight. By and large, they were the residual result of the movement in the balance of payments, that is, they were an induced rather than an autonomous capital movement. This is confirmed by a study made by Alienes showing a high positive correlation between the volume of these balances and the peso rate (while the latter was below par).<sup>23</sup> If the balances had been in the nature of an autonomous capital export, the opposite result would be expected, that is, the peso ought to have weakened as the banks accumulated such funds. A strengthening of the peso in the face of capital exports clearly indicates that the movement of funds was of an induced character. It may be added that these foreign balances influenced in no way the banks' exchange position and did not involve any exchange speculation. The exchange position would

<sup>23</sup> Quoted in Pazos, *La Banca*, p. 31n.



have been the same if the funds had been carried in the form of dollar currency in Cuba.

In the light of these considerations, it is clear that the balances held by the private banks have somewhat the same economic significance that central bank exchange and gold reserves would have. There is no more reason for insisting that these funds should have been brought to Cuba and employed in loans and investments there than for requiring a central bank always to expand to the maximum permitted by its reserve position. It is true, of course, that a central bank having large reserves might regard this as a justification for credit expansion, if such expansion seemed desirable on other grounds. In this sense, foreign balances in the hands of a central bank might have a beneficent effect upon credit policy that they seem to lack when held by private banks.

It is possible also that the banks' practice of holding foreign balances may exert an unfavorable influence upon the development of a market for internal government securities. In general, the head offices of the foreign banks seem to be averse to security purchases by their branches. In Cuba the credit standing of the government, at least during the late thirties, may have been sufficiently poor to discourage such investments in any case. But with an improvement in government credit, the question may eventually become a more concrete one.

## **PART IV**

# **THE SIGNIFICANCE OF CUBAN MONETARY EXPERIENCE**



## CHAPTER XII

### STRATEGIC FORCES IN THE CUBAN ECONOMY

THE EVENTS DESCRIBED in the preceding parts of this study have illustrated repeatedly the differences that separate an economy like the Cuban from that of a more mature country. A special set of strategic factors dominates the Cuban economic scene, and the cause and effect sequences typical of the island diverge from familiar patterns in many respects. In this chapter an attempt will be made to analyze the forces that govern the Cuban economy and to dissect the mechanism through which they operate.<sup>1</sup>

It has become customary in modern analysis to distinguish certain elements in the national income that may be regarded as predominantly independent of the level of income and others that are predominantly a function of income. This has proved a useful means of establishing something approaching a one-way chain of causation in a world where, at first glance, everything seems to depend upon everything else.

The elements that are largely independent of national income are investment, exports, and, to a lesser degree, government expenditures. Functionally dependent upon national income, with certain qualifications, are saving, imports,<sup>2</sup> and (again to a lesser degree) tax revenues. Each of the independent factors is conceptually the complement of one of the dependent factors — investment and saving, exports and imports, expenditures and tax revenues. The former constitute injections into the income stream, the latter are leakages. Full equilibrium exists

<sup>1</sup> The analysis made in this chapter of the strategic factors governing a typical export economy was first presented in condensed form in my essay "Fiscal Policy and the Budget" in *Economic Problems of Latin America*, ed. Harris.

<sup>2</sup> The terms "exports" and "imports" are intended to cover all credit and debit items in the current balance of payments.

only when the two components of each of the three pairs are equal to each other. An over-all equilibrium resulting in a constant national income exists also if the sum of the three dependent items is equal to the sum of the independent ones, but in that case there will be continual changes in the national debt or in foreign exchange reserves, or both.

These equilibrium conditions, in conjunction with the functional relationships between the dependent variables and national income, constitute the causal nexus between the independent factors and the national income. A rise in exports, for instance, will lift national income up to the point where the aggregate increase in the leakages is sufficient to balance the added injection. The extent of the probable increase in income can be measured by a multiplier formula employing one or more of the independent variables as multiplicand and the first derivative of the function relating national income and one or more of the dependent variables as part of the divisor.<sup>3</sup>

The main weakness of this type of analysis lies in the fact that the independent variables are not fully independent, while the dependent variables are not fully dependent. Investment, exports, and government expenditures are likely to be affected by the level of national income, or changes of this level, to a greater or lesser degree, a phenomenon which, in the case of investment, is commonly known as the acceleration effect. The effects of such "induced" investment, exports, or government expenditures could, of course, be estimated by the same multiplier formula that was used in gauging the effects of their independent counterparts, once the magnitude of the induced

<sup>3</sup> If the assumed rise in exports starts from a position of full equilibrium, the new level of national income probably will not imply full equilibrium of the three pairs of variables. The rise in national income resulting from higher exports will not be sufficient to lift imports to the new level of exports, since some of the additional income will leak into savings and taxes. In the new position, therefore, exports will exceed imports, while investment and government expenditures, remaining unchanged, will fall short of savings and tax payments, respectively. Full equilibrium will not be attained until after the accumulation of exchange reserves and the budget surplus has led to changes in prices, income distribution, tax rates, etc., that sufficiently modify the existing functional relationships to permit a full adjustment. The same is true, of course, if the initial impulse originates from an increase in investment or government expenditures.

items is known. For a calculation of these magnitudes, however, there appears to be no plausible statistical basis.<sup>4</sup>

An analogous difficulty appears in connection with the dependent variables. Savings, imports, and tax revenues may vary autonomously and thereby upset the presumed functional relationship to national income. There is no *a priori* basis for anticipating changes in savings and import habits, although the effect of changing tax laws naturally can be forecast within reasonably close limits. Since one can never be certain that unpredictable changes in savings and import functions are not actually going on, any forecast of the effect of changes in the independent variables based on the assumption of invariant functional relationships becomes hazardous.

### I. THE THREE PAIRS OF VARIABLES

It is clear from the foregoing that the three pairs of variables are not the ultimate realities for an analysis of fluctuations in Cuban income and employment. They are merely a convenient summarization of the underlying factors — consumption habits, entrepreneurial attitudes, price-cost relationships, income distribution, monetary factors, technological developments, political conditions, the state of world trade and world markets, and many others. We are not excused, therefore, from considering these basic factors when we employ the “short-hand” type of analysis here proposed. What this analysis does for the economist and the policy maker is to provide a framework for research and action, and to concentrate attention upon certain key elements. To establish a firm basis for the use of the analysis, therefore, we must survey the major factors underlying

<sup>4</sup> On the basis of certain assumptions as to the durability of equipment, it is possible to hypothesize regarding the magnitude of induced investment. The great number of imponderables that enter into this situation, however, deprives such procedures of all practical significance. The effect of a higher national income and larger tax revenues upon current government expenditures is a political matter and hence largely unpredictable. It is only in the case of induced exports that an estimate is possible in principle on the basis of the effect that a higher national income at home will have upon income abroad, and hence upon foreign imports. Statistically, however, the task is probably unmanageable except in the case where induced exports are *prima facie* equal to zero.

the three pairs of variables. Particular attention must be given to the degree to which the workings of these factors fortify or impair the dependence or independence of the respective variables with regard to national income.

To begin with, we shall look into a matter that affects each of the three dependent variables equally: the volatility of the Cuban price level. In multiplier analysis it has been customary to postulate a constant level of prices. This is done, in the first place, because an analysis dealing with short-run income fluctuations involves the assumption that there are unutilized resources. As long as such is the case, there is no reason, ordinarily, to expect prices to rise before full employment is being approached. In the second place, it is believed that changing prices are likely to unstabilize the relation between national income and the dependent variables by changing the distribution of income and by altering consumption and saving habits.

The postulate of constant prices is a fairly realistic one for an industrial economy in which administered prices predominate. For a raw-material economy like the Cuban, however, it is altogether inadmissible, no matter how large the volume of idle resources. The price of sugar, upon which a large segment of the Cuban wage structure is built, tends to rise sharply whenever demand shows signs of picking up, even if the volume of output is still far below capacity. The prices of many domestic consumer goods tend to follow. These fluctuations undoubtedly are accompanied by substantial changes in the distribution of income, although no statistical data exist to measure them. There is reason to think, nevertheless, that in Cuba the relation between national income and the dependent variables is less likely to be disrupted by a changing price and income structure than it would be in an industrial economy, because changes in prices and income distribution are themselves part of the cyclical pattern and hence fairly closely related to the change in national income.<sup>5</sup> In Cuba, therefore, the factors that ordinarily

<sup>5</sup> Alienes has shown, for instance, that a high degree of correlation exists between national income and the price of sugar. The relationship is considerably closer than that between national income and the quantity of sugar produced (Alienes, *The National Economy of Cuba*, p. 54).

are regarded as disturbances tend to become integrated into the normal relation between income on one hand, and imports, saving, and tax revenues, on the other. Some evidence of this will appear in the following discussion of the different pairs of variables.

#### A. EXPORTS AND IMPORTS

Exports are by far the most important of the independent variables. In 1929, the last predepression year, they amounted to 292.6 million dollars, and in 1947, to 772.7 million. This contrasts with government expenditures of 85.4 million in the earlier, and 213.0 million in the latter year.<sup>6</sup> No data exist as to the volume of private investment, but from the character of the Cuban economy it is plain that the amount must be considerably smaller than either exports or government expenditures.

Cuban exports may be presumed to be almost completely independent of national income; in other words, there are practically no induced exports. This may be concluded from the fact that changes in Cuba's imports are too small to have a significant influence upon the national income, and hence upon the imports,<sup>7</sup> of any of the countries from which she buys. A change in Cuban imports from the United States of as much as 50 million dollars, for instance, would hardly make a dent in the income of the latter country and certainly would not significantly affect American purchases from Cuba.<sup>8</sup>

Less easy to answer is the question of the closeness of the relation between Cuban imports and national income — the stability, that is to say, of the import function. In strict logic, a precise relationship can be expected to exist only between national income and imports for direct and indirect *consumption*, not total imports including investment goods. Where national income itself is largely determined by investment, as in the United States, the relation may in practice be safely extended to cover all kinds of imports. In Cuba, where exports are the prime

<sup>6</sup> The two latter figures represent regular budget appropriations.

<sup>7</sup> From Cuba and elsewhere.

<sup>8</sup> Cuban purchases from the United States very probably do have an influence on American tariff and trade policy vis-à-vis Cuba, and may thus exert a strong indirect effect upon Cuban exports, but that is a point of a different order.



mover, this procedure is not entirely legitimate, and more accurate results will perhaps be obtained by restricting the analysis to consumer goods imports. It will shortly appear, however, that investment activity in Cuba, as well as national income, is so strongly influenced by the volume of exports that investment and income ordinarily tend to move in close harmony. No great harm will be done, therefore, by dealing with total imports rather than consumer-goods imports only.<sup>9</sup>

The stability of the import function may be threatened by a variety of factors. The first is a change in relative price levels in Cuba and abroad, not associated with changes in national income.<sup>10</sup> In a diversified economy such changes might produce extensive substitutions of domestic goods for foreign, or vice versa. In Cuba, however, with her limited range of domestic output and with only a modest productive capacity in many lines, the elasticity of substitution between foreign and domestic goods is small, and relative changes in price levels, therefore, should not be very disturbing.<sup>11</sup>

Another factor capable of interfering with the import function results from changes in the distribution of income. It seems certain that the incomes of the wealthier classes, particularly those connected with the sugar industry, fluctuate more widely during the cycle than those of wage earners and agricultural workers. The fact, however, that these changes largely fall into a cyclical pattern integrates them, to some extent, with the import function. That is to say, insofar as these changes in income distribution are a regular accompaniment of the ups and downs of income, the import fluctuations that result from the latter tend also to reflect the former more or less regularly.<sup>12</sup> Income redistribution thus tends to be eliminated, at least in part, as a disturbing element. An even stronger reason for not attaching

<sup>9</sup> Imports for subsequent reexport, which also may undermine the import function, do not play an important role in Cuba.

<sup>10</sup> Price changes closely associated with national income changes, as pointed out previously, will tend to become integrated into the import function and need not be a major threat.

<sup>11</sup> See more detailed discussion, pp. 233 ff.

<sup>12</sup> The policy of raising wages by decree and thereby "spreading the boom thin," pursued by the Grau government since 1944, may have disturbed the existing pattern or even set a new one for the future.

much importance to changes in the income distribution is that even the lower classes consume a substantial amount of imported goods, such as rice, lard, and beans — to mention only a few basic necessities. The effects even of a noncyclical redistribution should, therefore, remain fairly small.

A third potential element of instability is a change in tastes which may produce a rise or fall in imports without corresponding movements in national income. Very little can be said on this highly unpredictable subject, except to point out that in a country with a relatively low standard of living the likelihood of major swings in consumption habits is very much less than in a fashion-dominated market like the American.

More important than any of the preceding disturbances are the effects of tariff legislation. It is certain that the introduction of a protective tariff in 1927 brought about considerable changes in the volume and pattern of Cuban imports, and that it stimulated the domestic production or processing of numerous commodities previously imported. Changes of this kind have been referred to as "autonomous" variations in imports, which, for the purpose of multiplier analysis, ought to be classed with the independent variables.<sup>13</sup> After the effects of new tariffs have fully worked themselves out, however, a new import function may again be expected to establish itself, unless further tariff changes are introduced. The problem is mainly a transitional one.

Closely allied to the effect of tariffs, but more persistent in its operation, is the gradual process of industrialization which has been going on in Cuba even in fields that have little or no protection, and which received a special impulse during the war. The progressive substitution of new domestic products for imported goods slowly reduces the proportion of imports that corresponds to a given level of income. The familiar observation that industrialization leads not so much to a reduction in the volume of trade as to a change in its composition does not alter the fact that the average propensity to import declines when income rises and imports remain constant.

<sup>13</sup> See C. Clark and J. G. Crawford, *The National Income of Australia* (London, 1938), p. 95.

Of the five potential disturbances listed, all but the last two seem to suggest that the import function is more stable in Cuba than in a more mature country. On balance this probably remains true even if the destabilizing influence of tariffs and progressive industrialization is taken into account, since similar processes are going on even in the more developed countries, although more slowly. The statistical determination of the Cuban import function would, therefore, be a worth-while task when the necessary national income data become available.

#### B. INVESTMENT AND SAVING

No statistical information is available regarding the volume of private investment in Cuba, and little can be said about it beyond noting the presumption that it ranges below exports and government expenditures in magnitude. During the successive periods of growth in the sugar industry, primarily during the years 1915-1921 and 1923-1925, industrial expansion no doubt was considerable. New investment in sugar mill machinery alone averaged 14.3 million pesos annually for the earlier and 11.6 millions for the latter period.<sup>14</sup> An inspection of the property accounts of Cuban corporations, however, would not yield very useful data, since during those hectic years of high corporation finance generous write-ups of assets were the rule.

How much of Cuban investment may be regarded as "independent" and how much as "induced"? The concept of induced investment rests upon the fact that when national income rises, the increasing demand for consumer goods calls for an expansion of equipment and inventories. In practice, however, it often is difficult to point to any particular piece of investment and say whether it is induced or independent. To some extent the classification depends on how broadly the term "product" is defined. Given a very narrow definition,<sup>15</sup> there may frequently be no

<sup>14</sup> Foreign Policy Association, *Problems of the New Cuba*, p. 222. While investment in machinery, all of which has to be imported, does not add to the Cuban income stream, it must be included for the purpose of the present analysis, unless the import function is so defined as to exclude imports of investment goods.

<sup>15</sup> The definition, for example, suggested by Professor Edward Chamberlin in *The Theory of Monopolistic Competition* (Cambridge, Mass., 1939), Chap. iii.

preëxisting market for the product of a new plant or machine. The investment would thus have to be put into the independent category, even though a rising national income may be generating demand for this general class of products. Again, investment may be induced by shifts in demand not associated with a rise in income, which would bar the investment from being classed as "induced" in the meaning of the acceleration principle. Even *ex post*, therefore, the statistical determination of induced investment would be immensely difficult. *Ex ante*, the chances are even slimmer.<sup>16</sup> This naturally detracts from the usefulness of the distinction for quantitative analysis, although qualitatively it remains a valuable tool.

In spite of the difficulties of statistical determination, some general facts about the nature of Cuban investment stand out plainly. Since a large part of the manufactured consumer goods purchased by Cubans has to be imported, an increase in income is not likely by and of itself to induce the proportionate amount of investment in Cuba that it would in the United States. A rise in foreign demand for sugar, on the other hand, might bring forth a good deal of new investment, or would have done so before the industry was built up to its present large capacity. The high liquidity resulting from an active balance of payments likewise contributes substantially to all forms of investments. For an understanding of the Cuban economy, the main point to be kept in mind is that an increase in national income resulting from higher investment or government spending will not be self-stimulating through induced further investment to the same degree as an export boom.

The next subject of inquiry is the stability of the savings function — the degree, that is, to which the dependent variable "saving" is, in fact, functionally dependent upon national income.<sup>17</sup> As in the case of the import function, there are a variety

<sup>16</sup> In addition to the problems of definition, an attempt at statistical determination of induced investment would come up against the fact that investment frequently is the *combined* result of induced and independent elements.

<sup>17</sup> The savings function is the reciprocal of the more commonly used consumption function, the propensity to save being equal to unity minus the propensity to consume. In the present context it is more convenient to deal

of potentially disturbing factors, which must be investigated. First among these are changes in saving habits. Since a very large part of the Cuban population does not save at all, such changes probably are less important than in a wealthier country. In view of the more volatile temperament of the Cuban consumer, one cannot even be sure that Cuba experiences the same lag in the adjustment of consumption to income changes which seems to be the rule in the United States.<sup>18</sup>

A second potential disturbance is the variability in purchases of durable consumer goods. This likewise affects Cuba less than a wealthier country, owing to the relatively low standard of living of the Cuban people. Such fluctuations should not be a major threat to the saving function.

A third destabilizing element is corporate saving. Corporate policies are not governed by psychological propensities to the same degree as individual saving. A substantial part of the profits of Cuban corporations, however, is paid out to foreign investors or accumulated on their behalf. Whether such proceeds are paid out or retained makes no difference to the Cuban economy. Therefore corporate saving, too, should press less heavily against the stability of the saving function than in a creditor country.

Finally, account must be taken of changes in the distribution of income. While in the case of imports their influence tends to be mitigated by the high consumption of imported products even among the lower classes, it is all the greater in the case of savings, because of the great discrepancy in saving habits between the lower and upper income groups. It was pointed out in connection with imports that income shifts are themselves related in some measure to national income changes; to a certain degree, therefore, their effects are integrated into the saving function. It is doubtful, however, whether the relation between the level of income and its distribution is sufficiently

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with the savings function, since consumption is being broken down into imports and domestically produced goods.

<sup>18</sup> See Paul A. Samuelson, "Full Employment After the War," *Postwar Economic Problems*, ed. Seymour E. Harris (New York, 1943), p. 35; also Mordecai Ezekiel, "Statistical Investigations of Savings, Consumption, and Investment," *American Economic Review*, March 1942, p. 33.

close to make the saving function a very stable one. There is reason to think, therefore, that the saving function may be less stable, on the whole, than the import function.<sup>19</sup>

### C. GOVERNMENT EXPENDITURES AND REVENUE

It has been the general practice in the present type of analysis to treat an excess of expenditures over revenues, rather than expenditures as a whole, as the stimulating factor. This seems to imply an underlying belief that expenditures and revenues normally are, or should be, determined with reference to one another and that the deficit is tacked on in bad times without becoming an integral part of the budgetary structure. The view has increasingly been gaining ground, however, that expenditures and revenues should be determined primarily with regard to the economy's need for government services and the influence of taxation upon national income. A balance between government income and outgo, according to this view, should be achieved only when the other stimulating factors are sufficient to provide full employment.

This approach to fiscal policy suggests that government expenditures as a whole should be treated as the independent variable, while tax revenues are regarded as another leakage.<sup>20</sup> In Cuba, however, the connection between expenditures and revenues is still very close. The Cuban government is so lacking in credit resources that its expenditures cannot greatly exceed its revenues. Its budgetary control, on the other hand, is so deficient that expenditures always tend to expand to the level of available revenues. It taxes all it can and spends all it gets, or a little more. Government expenditure, therefore, is far from being completely independent, except at the margin. A substantial part is induced: national income determines tax revenues, and the latter, to a large extent, determine the level of expenditures.

<sup>19</sup> See also p. 200, n. 12.

<sup>20</sup> The war has drastically demonstrated that in a mature country government expenditures are almost completely independent of tax revenues. The only remaining connection between the two has been the real resources calculus, higher taxes permitting larger government expenditures because they free resources by absorbing purchasing power.

The lack of complete *independence* on the part of expenditures is matched by a lack of complete *dependence* on the side of revenues. There can be no stable relation between national income and tax revenues unless there is a stable tax system. The latter has been conspicuously absent, for the Cuban government has been extraordinarily ingenious in uncovering new sources of tax revenue. Given a stable tax system, however, Cuba probably would have a fairly stable revenue function. Price changes would be a major disturbance only if a progressive income tax played a predominant role in the budget, which so far is not the case. Shifts in the income distribution, for the same reason, should not have a great deal of influence. Changes in imports could be unsettling, it is true, because tariffs are one of the leading sources of revenue. Since imports themselves, however, are a fairly close function of income, their fluctuations should not affect the relation between income and revenues. A factor, on the other hand, that probably has considerable influence upon the revenue function is the efficiency with which taxes are collected. This varies, no doubt, with the political climate.

In general, a survey of these actual and potential disturbances does not suggest that the revenue function is any more unstable in Cuba than it is in the United States. The main source of instability in both countries is the instability of the tax structure itself.

It needs hardly to be said that Cuban statistics are still very far from permitting the practical application of these functions to the problem of estimating income fluctuations. No "model building" is possible until very much more complete data are available than at present. For the time being, the analysis so far presented can at best have qualitative value: it helps to focus attention upon the significant variables and shows their interaction and their relative importance.

## 2. THE ROLE OF THE QUANTITY OF MONEY

It will be noted that the quantity of money does not appear among the determining variables discussed in the preceding

sections. This reflects the essential character of the "income approach," which concentrates upon the spending and receipt of money rather than upon its availability. Nevertheless, the quantity of money is an important element because, together with other factors, it conditions the behavior of the variables that determine income. It is all the more important in an economy in which exports and imports play a major role, because an active or passive balance of payments automatically changes the money supply.

When, in a situation of full equilibrium, a given amount of investment is financed out of current savings, there is no change in the money supply. But when over-all equilibrium is maintained by the coexistence of an excess of exports over imports and an equal excess of saving over investment, there is a steady increase in the money supply and in the reserves of the banks. From an income standpoint, everybody's position remains what it would be in a full equilibrium situation, but now the cash balances of the public and the resources of the banking system are increasing by an amount equal to the excess of saving over investment. Over-all liquidity in this situation is constantly on the rise. When the inverse situation prevails — a balance of payments deficit on current account being offset by an excess of investment over saving — liquidity constantly diminishes, unless maintained by new internal money creation.

The cash savings resulting from an excess of exports over imports will tend to increase investment, in a degree dependent upon the monetary habits of the public.<sup>21</sup> In a highly developed country the effect of liquidity upon investment may be rather small, as the experience of the United States during the thirties has made distressingly obvious. But in underdeveloped coun-

<sup>21</sup> Although the main effect of a growing cash balance is likely to be a pressure to seek investment, the holder may also find himself tempted to consume more, that is, to reduce his rate of saving. That is to say, an export boom that forces people to hold more cash is likely to produce a slightly higher propensity to consume than would an equivalent investment boom. It should be noted, however, that an intensive accumulation of securities, as a result of high investment or of government deficits, may in the long run also increase the propensity to consume at given income levels, although probably less so than the accumulation of cash.



tries money has not yet been affected by this creeping paralysis, and the willingness of investors to hold idle cash usually has shown itself to be rather limited. Among the presumptive reasons one may cite the chronic capital shortage of such countries, the correspondingly high return on investment, the lesser confidence in the currency and in the banks, and the lack of broad securities markets where money may lie in wait for buying opportunities. All of these help to bring about an atmosphere in which idle money tends to be an anomaly and where the quantity theory of money retains some validity.<sup>22</sup>

In a country with a highly developed capital market, such expansion of investment as may result from a rising money supply would mainly come about through a fall in interest rates and through greater receptivity of the securities markets. In Cuba, where the capital market is still in a rudimentary stage, the importance of these factors is considerably smaller. A great deal of investment still tends to be carried out by the savers themselves, small groups of capitalists joining together in the promotion of new enterprises. In many cases, furthermore, the function ordinarily performed by the market may find a substitute in the direct contact between lender and borrower, as in the case of mortgage loans. It must be added that the high propensity to invest available funds leads, in good part, not to an increase in physical investment, but to a speculative bidding up of existing assets, money passing from hand to hand without being able to find a resting place.

The inflow of foreign exchange, by increasing bank reserves, also creates the basis for large-scale additional bank credit expansion. In contrast to many other Latin American countries, however, this factor has been of relatively little importance in Cuba since the crash of 1920. The surviving banks, mostly foreign, have shown themselves quite insensitive to the pres-

<sup>22</sup> Other reasons for the tendency of money to remain in motion, which, however, do not bear directly upon investment, are the facts that many income receivers do not save at all, that a large part of transactions is carried on in currency, and that habits and routines are less flexible than in a more sophisticated environment. At the same time, it must be noted that some of the factors that discourage the holding of idle cash sometimes have the effect of stimulating the hoarding of coins or of dollar bills, for obvious reasons.

sure of large reserves, with the result that excessive bank credit has not been a major aggravation of Cuban inflation, although it remains as a potential threat.

In an economy dominated by investment rather than exports, an increase in liquidity during a cyclical upswing would normally come about only through the deliberate action of the monetary authorities.<sup>23</sup> A consequent rise in investment, therefore, would have to be regarded as autonomous, since the change in liquidity would in no way be functionally related to the simultaneously occurring rise in income. In an export economy, on the other hand, the exports that lift income at the same time increase liquidity. The resultant investment, therefore, while not induced by higher income, is nevertheless a function of the same factor that governs income. We cannot, accordingly, regard it as autonomous. It seems necessary to recognize that in an export economy allowance must be made for a third type of investment in addition to the familiar categories of autonomous and induced investment, which is the result of the rising liquidity uniquely inherent in the cyclical process of such an economy.

### 3. THE TROUBLES OF AN EXPORT ECONOMY

In the light of these considerations regarding the quantity of money as a strategic factor in the Cuban economy, the fact that exports, not investment, represent the main independent variable takes on added significance. The power of exports to induce additional investment and government expenditures is greater than that of these variables themselves. Thus exports acquire an importance as a strategic factor far beyond even their quantitative predominance, which in itself is substantial. The relative importance of exports to the Cuban economy probably is considerably greater than that of investment to the American.

From the policy-maker's viewpoint, this has various discouraging implications. In the first place, it shows how heavily

<sup>23</sup> The great increase in liquidity that the American economy experienced during the middle thirties, largely owing to the inflow of capital, was an evident exception to this general rule.

an export economy like Cuba's is dependent for its normal well-being upon a factor outside its control — the purchasing power of foreign countries. The impact of foreign depressions is more severe than it is in maturer countries.<sup>24</sup> The means of defense, on the other hand, are much weaker.

In the first place, an export economy does not lend itself easily to governmental stimulation, except by the awkward method of purchasing unexportable surpluses. Unlike public works, such purchases add nothing of permanent value to the economy, and the piled-up stocks are likely to depress the market and to become a future source of embarrassment. Public works and other forms of internal stimulation find their limits in the lack of mobility of productive factors. In the second place, insofar as monetary and fiscal policy succeeds in raising national income, imports will rise sharply, and a passive balance will develop. Within a relatively short period, a successful policy of domestic stimulation may lead to an exhaustion of exchange reserves and will then confront the country with a choice between depreciation and tight exchange control. Either policy may serve to equilibrate the balance of payments; the enforced reduction in imports, however, shunts part of the demand which had previously been directed abroad back upon the domestic economy, where it meets with an inelastic supply in many lines. Prices then begin to rise rapidly. Soon further depreciation or control will become necessary. To avoid these hazards, fiscal and monetary policy in Cuba must operate within much more modest limits than in the United States.

A further obstacle to effective monetary stimulation lies in the low multiplier of the Cuban system. In the absence of statistical information one can do no more than guess, but it appears almost certain that the sum of the marginal propen-

<sup>24</sup> This might not be true of an export country where a large sector of the economy is in effect self-sufficient, having only slight contact with the market economy. Under such conditions, which are characteristic of many Latin American countries, labor that has become unemployed in the market economy tends to be reabsorbed into the self-sufficient orbit, where it can weather the depression. The existence of large-scale unemployment thus tends to be avoided, or more accurately perhaps, to be obscured, by cyclical migrations of part of the labor force from one sector of the economy to another. The Cuban economy, however, is almost entirely of the market type.

sities to import and to save is higher in Cuba than in the United States. To achieve a given effect, therefore, a correspondingly greater volume of credit creation and deficit spending probably is required.

The lower multiplier, ironically enough, means that in a certain sense the Cuban economy is more stable than that of the United States. This is true if we interpret stability with respect to the intensity with which the economy responds to a change in the independent elements. In Cuba a stimulus of proportionately equal magnitude will cause a relatively smaller movement than in the United States. In another sense, however, the Cuban economy is less stable, and, unfortunately, the latter in practice has proved the more relevant sense. Stability, in this sense, depends upon how far national income must fall below full employment in order to reach its theoretical minimum level — the point where leakages become zero in the aggregate and where, in the absence of stimulation, the economy would be maintained by a kind of circular flow.<sup>25</sup> It is evident that the import leakage is likely to disappear — if ever — only at a much lower income level than the savings leakage, since for imports there is nothing analogous to the phenomenon of “dissaving” which offsets such positive saving as still continues at low income levels. An economy, therefore, that depends upon exports and imports can drop much lower than one dominated chiefly by investment and saving. It is true that exports are less likely to go to zero than investment, and rock bottom level, for this reason alone, will never be reached. But Cuban exports, nevertheless, are capable of enormous fluctuations, owing mainly to the familiar volatility of the price of sugar, and this lends a special importance to the fact that the rock bottom level lies so low. In this very important sense, an export economy like the Cuban is much more unstable than an investment economy.

A further element of instability not present in an investment economy is added to the Cuban case by the role played by the changes in the money supply discussed in the previous section.

<sup>25</sup> See Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York, 1941), Chap. xiii.

In an investment economy, the monetary mechanism acts as an automatic brake upon a cyclical process of expansion or contraction. As the boom progresses, interest rates rise, the capital markets become congested, and new financing becomes more difficult. After the turning point has been passed, the stringency tends to be relaxed and financing becomes easier.<sup>26</sup> The investment economy, therefore, tends to become less liquid during a boom and, conversely, to gain liquidity during a depression. An export economy, on the other hand, gains liquidity during the upswing and becomes less liquid during the downswing, because the balance of payments, which generates the cycle, at the same time changes the money supply. During the boom, in other words, the supply of loanable funds tends to run ahead of demand and runs behind during the depression. This phenomenon derives particular importance from the high sensitivity of an export economy to the volume of money. The total effect is to increase the range of possible fluctuations in an economy like the Cuban, as contrasted with that of the United States.

#### 4. THE ADJUSTMENT OF THE BALANCE OF PAYMENTS

The analysis of the forces dominating the Cuban economy provides a clue to the mechanism that equilibrates the balance of payments. A detailed computation of the main elements in this balance for the years 1919-1947 is presented in Appendix B, but since neither price indexes nor national income data are available over sufficiently long periods, no attempt is made to trace out the actual working of the process. A discussion of the underlying principles, however, is well worth while.

So far, we have regarded the balance of payments as a source of disturbances and have in fact found in it the most important determinant of Cuban national income. It is clear, however, that the balance of payments surplus or deficit which raises or lowers national income is unlikely to be a permanent feature.

<sup>26</sup> It must be noted, however, that this does not hold true for new ventures with a high degree of risk. The decline in risk premiums which is typical of a boom period frequently makes possible at that time the financing of enterprises that in a depression would have difficulty in securing funds. Moreover, the policy of the monetary authorities may modify considerably the inherent tendencies of the monetary mechanism.

If there are no changes abroad that bring the condition to an end, a corrective adjustment eventually will follow within the Cuban economy, tending to reestablish approximate equilibrium.

In principle, the adjustment may be brought about by one of two mechanisms: the price mechanism, emphasized by the "classical" theory, or the income mechanism, stressed by the "modern" theory. In practice, both are always operative, but it will presently appear that in Cuba the income mechanism does most of the work. The two approaches differ slightly in their analysis of the process of expansion, but this is not the essence of their distinction. Nor does the difference lie in the assumptions that need to be made regarding gold flows or foreign exchange accumulation or the existence of unemployed resources. The essential difference between the two approaches is rather the assumption, in the case of the price mechanism, that a change in relative price levels at home and abroad will lead to large-scale substitution between foreign and domestic goods.<sup>27</sup> The classical approach assumes, in other words, a shift in the import function. The income mechanism, on the other hand, envisages a change in the volume of imports in accordance with changes in income proceeding along a stable import function.<sup>28</sup>

<sup>27</sup> For a comment on the methodological distinction between the two approaches, see Gottfried Haberler, *Prosperity and Depression* (3rd ed.; Geneva, 1941), p. 473.

<sup>28</sup> This distinction, too, becomes somewhat uncertain if the substitution effect due to price changes is sufficiently regular from cycle to cycle to be integrated into a stable import function. In the Cuban case there is some justification for assuming that price changes do not interfere substantially with a stable import function. The main reason for this, however, is that the limited range of Cuban output does not allow much substitution between foreign and domestic goods, even if there are major price changes. An opportunity for large-scale substitution would almost certainly destabilize the import function.

Another way of illustrating the difference between the price and the income mechanism is to draw an ordinary demand curve for imports, relating their quantity to their price. In that case, the price mechanism assumes a movement along the curve, while the income mechanism assumes a shift.

It is important to note that changes in the price of imports, besides occasioning a substitution effect, ordinarily also mean a change in real income for the importing country. Thus the classical approach embodies also a certain income effect. The same applies to changes in the price of exports.

Both mechanisms require for their proper functioning an environment where income and prices are dominantly influenced by the balance of payments. Otherwise, a fall in investment, for instance, might produce a contraction at a time when the state of the balance of payments called for expansion. In every other respect, however, the conditions under which the two mechanisms can be expected to function are diametrically opposed.

The high elasticity of substitution required by the price mechanism will prevail only if a country's output is well diversified and if its foreign trade is only a small fraction of its national income. In that case domestic substitutes will be available for most imports, and the demand and supply schedules of the domestic market will have virtually perfect elasticity for the small quantities by which imports and exports need to change in order to regain their balance.<sup>29</sup> Unfortunately, the need for a low ratio of trade to income conflicts with the other requirement that income should be dominantly influenced by foreign trade. The two conditions can coexist only if fluctuations in the other independent variables, investment and government expenditures, are very small. In the United States, for instance, where the elasticity of substitution between foreign and domestic goods is fairly high, fluctuations in the other variables are large. Hence the balance of payments fails to dominate national income and neither type of mechanism can be expected to function well.<sup>30</sup> In a country like France, where domestic investment has been relatively small and relatively stable, the price mechanism might have a better chance, but on the whole its practical effectiveness is always limited. This is all the more true in periods when large unemployed resources cause price inflexibility in countries where prices are predominantly of the administered type.

The income mechanism, on the other hand, can be observed in its purest form when the elasticity of substitution between domestic and foreign goods is small. A small elasticity will

<sup>29</sup> For a detailed discussion of this problem, see pp. 220 ff.

<sup>30</sup> See Arthur I. Bloomfield, "The Mechanism of Adjustment of the American Balance of Payments, 1919-1929, *Quarterly Journal of Economics*, May 1943, pp. 335-339.

prevail if the country is undeveloped and if foreign trade represents an important fraction of income. These conditions also insure that income will be dominated by foreign trade. A rise in exports, for instance, will then lead to a given rise in income and thence to an appropriate rise in imports.

A complete adjustment of the balance of payments, however, cannot be expected from an export-created income expansion alone, since some of the rise in income will leak into saving and taxes.<sup>31</sup> With the aid of induced and liquidity-stimulated investment, imports may reach the necessary level. If they do not, there can be no full adjustment until and unless the price mechanism becomes sufficiently operative to effect at least a mild shift in the import function, as it probably will even under very unpromising circumstances. If conditions favor the working of both mechanisms, the adjustment will come about more quickly and more surely.

Cuba presents, of course, an almost perfect setting for the pure income mechanism. The economy is completely dominated by the balance of payments, and for this reason the domestic elasticity of substitution is low as well, because of the very incomplete diversification of output. Abroad the elasticity of substitution between Cuban exports (sugar) and local production likewise is small, because Cuban sugar exports represent so large a proportion of total sugar supplies and, more recently, because the quota system makes demand almost completely inelastic. The income mechanism thus can operate with effectiveness and with a minimum of interference from non-income elements, while the price mechanism has little opportunity to become effective, although, of course, it can never be entirely out of action.

The predominance of the income mechanism in Cuba casts a shadow of doubt upon the usefulness, at least for Cuban problems, of a time-honored concept of international trade theory — the equilibrium rate of exchange. A few brief remarks on this point must suffice here; the broader implications of exchange rate variations are the subject of the next chapter.

<sup>31</sup> Cf. F. Machlup, *International Trade and the National Income Multiplier* (Philadelphia, 1943), pp. 56 ff.



The exchange rate is the connecting link between foreign and domestic price levels; the importance of the equilibrium rates thus is closely tied up with the price mechanism. If the price mechanism is relegated to a secondary position, what becomes of the equilibrium rate?

It has long been recognized that a different equilibrium rate must be assigned to each income level, once variations in income are admitted into the analysis.<sup>32</sup> This means income changes not only at home but abroad; the number of possible combinations, therefore, is endless. But where the price mechanism has little influence, the equilibrium rate ceases to be clearly defined even if domestic and foreign incomes are given. In this the Cuban system differs radically from the industrial economies of Britain or the United States, where a few per cent in the price — or in the exchange rate — may decide whether their products can compete in the world market on even terms or not.

The conclusion is unavoidable that the equilibrium rate for Cuba is indeterminate within a fairly wide range. This seems to imply that it would not be good policy for the monetary authorities to alter the exchange rate in order to offset moderate price fluctuations. It likewise implies that once the decision to alter the rate has been taken, it is not necessary to seek a hair-trigger adjustment before restabilizing it. Neither conclusion, however, necessarily means that rate changes should be eschewed if price fluctuations continue to be as violent as in the past. In the next chapter we shall examine what advantages a policy of flexible rates might have offered to Cuba during various periods of her monetary history.

<sup>32</sup> Cf. R. F. Harrod, *International Economics* (London, 1933), pp. 152-158.

## CHAPTER XIII

### THE PROS AND CONS OF DEPRECIATION

THROUGHOUT THE CHECKERED COURSE of her monetary past, Cuba has maintained virtually stable exchanges, with the exception of the mild depreciation of the peso during the years 1939 to 1941. Although in 1933 the peso declined *pari passu* with the dollar, this can hardly be regarded as depreciation from Cuba's viewpoint. One must look upon it rather as a way of maintaining stability vis-à-vis the country with which Cuba conducts about 80 per cent of her trade. In this sense, Cuba has maintained exchange stability practically throughout.

An analysis of Cuba's economic history, however, repeatedly forces the observer to ask himself whether the maintenance of parity with the dollar was really the wisest course. The occasions that immediately come to mind are the banking crisis and subsequent economic prostration of 1920-21, the nadir of the Great Depression in 1932-33, and finally the recession of 1938 and 1939, when depreciation did take place on a minor scale.

One may almost assume that depreciation of the peso would have been inevitable on the two earlier occasions had Cuba possessed an independent monetary system. It was the use of the dollar that was primarily responsible for the maintenance of exchange stability. To make depreciation possible under these conditions, it would have been necessary to create a new currency capable of being fixed at a lower parity, effectively eliminate the dollar from ordinary use, and convert all prices, debts, and contracts into terms of the new currency.

Apart from the technical difficulty inherent in such measures, depreciation also would have met with the violent opposition of creditor interests. It might even have involved the risk of United States intervention under the Platt Amendment, which

permitted such intervention "for the maintenance of a government adequate for the protection of . . . property." Thus, the successful execution, at a time of crisis, of the monetary reforms required for an orderly and effective change in the value of the currency would have presented an almost insoluble problem. Cuba in fact was the prisoner of her monetary institutions.

Nevertheless, although these somewhat extraneous considerations may have effectively prevented depreciation from becoming a realistic policy alternative, we may legitimately inquire whether this was to Cuba's advantage, or whether more flexible institutions would have been preferable. Moreover, present developments make it probable that Cuba eventually will have an independent currency, the value of which could be changed if necessary. It will therefore be of interest to examine the conditions under which exchange depreciation might be beneficial to Cuba, with reference both to past experience and future contingencies.

Despite the one-sidedness of this approach, we shall be fairly safe in neglecting to make it more general by considering the pros and cons of appreciation as well. Many of the theoretical points involved, of course, do apply, *mutatis mutandis*, to appreciation. The concrete case against appreciation, however, economically and particularly politically is overwhelmingly strong. No major Latin American country, with the exception of Venezuela, in recent years has engaged in substantial appreciation of its basic exchange rate.<sup>1</sup> Historically it is hard to envisage any period in Cuba's past when appreciation would have seemed advisable. For practical purposes, therefore, exchange flexibility in Cuba means flexibility downwards.

Under the International Monetary Fund Agreement, to which Cuba has subscribed, exchange rate movements in excess of 10 per cent are permissible only if required to correct a "fundamental disequilibrium." This provision recognizes that depreciation in one country may be deeply disturbing to other

<sup>1</sup> There have been upward adjustments of parts of multiple rate structures during the war in a number of countries and a relatively small revaluation of the single Mexican rate in 1941 following upon a series of devaluations.

countries and should therefore be resorted to only when there is a strong case in its favor. The concept of "fundamental disequilibrium," however, is a broad one on which agreement is unlikely once the attempt is made to spell it out. In this study we shall proceed by examining the appropriateness of depreciation, not in the light of possible meanings of "fundamental disequilibrium," but in view of conditions as they were and may be again. It seems probable, in any event, that the light which can be shed upon the meaning of "fundamental disequilibrium" by investigation of concrete cases, will be a good deal more illuminating than that which is cast upon the concrete case by a theoretical elaboration of the concept. In this way, some contribution may be hoped for to the question of what constitutes "fundamental disequilibrium" in an export economy.<sup>2</sup>

Independently, therefore, of the technical problems presented by Cuba's monetary structure, and of possible limitations imposed by rigid definitions of fundamental disequilibrium, we may proceed to investigate the impact of exchange depreciation upon the Cuban economy. In a country heavily dependent upon foreign trade, this impact naturally would be very pronounced. One of the most important effects, of course, would be that upon the value and the price of exports and imports — that is, upon the balance of payments and the terms of trade. Changes in this sphere would affect not only the absolute size of the Cuban national income but also its distribution, as well as the division of the national product between Cubans and foreigners. Another important effect would be that upon the price level of domestic goods and the level of wages. A noticeable modification of the price-cost structure in favor of entrepreneurs, that is, a decline in real wages, would have effects similar to those of a protective tariff. The aggregate change in all categories of prices — export, import, and domestic — would bring about an alteration in the value of debts, which might give further impetus to entrepreneurial activity. It also would enable debtors

<sup>2</sup> It should be noted that fundamental disequilibrium is only a necessary and not a sufficient condition for depreciation. It may prevail without justifying depreciation under the terms of the International Monetary Fund Agreement, if depreciation is not *necessary* to correct it.

to pay off obligations cheaply and to redeem mortgaged property that would have otherwise been foreclosed, thereby affecting the distribution of wealth and property. Finally, if depreciation were to facilitate substantial monetary and fiscal expansion, the effects of such compensatory action would become an important part of the picture.

Among the presumed effects of exchange depreciation, that carrying the largest weight and requiring the most detailed analysis is the effect upon exports and imports. The remaining problems are relatively simple, and their solution is in part predetermined by events in the foreign-trade sphere.

### I. CHANGES IN THE PRICE AND VALUE OF EXPORTS AND IMPORTS<sup>3</sup>

Two distinct adjustments are involved in the reaction of exports and imports to alterations in foreign exchange rates. One is the adjustment in the *price* of export and import goods, that is, in the terms of trade. The other is the adjustment in the *value* of exports and imports, that is, in the balance of payments.<sup>4</sup> The change, if any, in the terms of trade is virtually certain to be adverse to the depreciating country, but the movement of the balance of payments may be in either direction, with a presumption, however, in favor of its becoming more active.

As a first approximation, it is convenient to treat both types of adjustment exclusively in terms of the price elasticities of supply and demand for the exports and imports of the de-

<sup>3</sup> Since the writing of this section, a good many more refined investigations of the effects of depreciation upon balances of payments have appeared. If justification is needed for presenting the analysis here in its original form, in addition to what has been said in the preface, I should like to point out that whereas in the more recent treatments emphasis usually is placed upon balance-of-payments adjustment per se, the approach here employed, while less elegant, seeks to encompass all the adjustments in the economy—including those of domestic prices and of employment.

<sup>4</sup> The use of the terms "exports" and "imports" is to be understood with proper allowance for the nonmerchandise items in the current balance of payments. In most instances, the elasticities relevant to exports and imports proper can be applied also to these other items, although there are some important exceptions.

preciating country.<sup>5</sup> This approximation will have to be modified quantitatively, but not qualitatively, in the light of the effects that income changes due to an alteration in the balance of payments may have upon exports and imports, in accordance with the income elasticities of demand for the respective goods. Qualitative modifications are ruled out, because these income effects depend for their existence upon the original change in the balance of payments. Income effects can come close to nullifying the original change, but they cannot completely offset or reverse it, for with the disappearance of the original change in the balance of payments, the income effects themselves would disappear. The investigation of these effects, while necessary to give precision to the earlier analysis, is secondary to it.

The same cannot be said of the effects that a change in the price structure may have upon investment and hence upon income. Through acceleration or liquidity effects, for instance, or through the protection that depreciation affords to domestic industries, domestic investment may be stimulated to such an extent that an initial improvement in the balance of payments would be more than wiped out by the rise in income. Unlike income effects, therefore, the effects of price changes upon investment are capable of modifying qualitatively the effect of depreciation upon the balance of payments as estimated on the basis of price elasticities of exports and imports. A quantitative appraisal of this possibility is, of course, very difficult, but some attention must be given it.

#### A. ADJUSTMENT OF EXPORT VALUES AND PRICES

With these qualifications in mind, the conditions governing the various adjustments to depreciation may be stated. Beginning with exports, and taking first the adjustment of values, it is evident that depreciation will cause a rise in the value of exports (in domestic currency) that will be greater:

(1) the *greater* the elasticity of foreign demand (in terms

<sup>5</sup> See Joan Robinson, *Essays in the Theory of Employment* (London, 1937), pp. 183-209.

of foreign currency), as conditioned by the elasticity of foreign supply of similar goods;

- (2) the *greater* the elasticity of domestic supply of exports (in terms of domestic currency), as conditioned by the elasticity of domestic demand for these goods, *provided* foreign demand has an elasticity of greater than unity. If the elasticity of foreign demand is below unity, the increase in the value of exports will be greater the smaller the elasticity of domestic supply.<sup>6</sup>

It is important to note that the elasticity of foreign demand which is relevant to the present discussion is not that of the world demand curve for the goods in question as such. It is the elasticity of the world demand curve facing the individual depreciating country. In other words, the problem is one of monopolistic competition. The depreciating country is very much in the position of a firm in an industry, and the elasticity of the particular demand curve facing it depends upon the elasticity of supply of its competitors,<sup>7</sup> and even more upon its importance as a seller relative to the size of the market. Hence, even though world demand for a particular commodity may be quite inelastic, the demand curve facing an individual country quite possibly may be perfectly elastic.<sup>8</sup>

The conditions governing the adjustment in the *price* of exports differ significantly from those governing the adjustment of *values*. Depreciation will cause a rise in the price of export goods (in terms of domestic currency) that will be greater:

- (1) the *greater* the elasticity of foreign demand (in terms of

<sup>6</sup>In the case of a foreign-demand elasticity of less than unity, the foreign-currency value of exports will fall, of course. The conditions governing the adjustment of values are stated in terms of domestic currency—instead of in foreign terms as is more frequently done—in order to bring out the contrast with the conditions governing prices, for which domestic terms are more relevant.

<sup>7</sup>The influence of the elasticity of competitive supplies is taken account of in condition 1 by the clause "as conditioned by the elasticity of foreign supply."

<sup>8</sup>Where conditions of monopolistic international competition prevail, which is the normal case if the depreciating country is an important supplier, the elasticity of competing supplies will depend in good part upon whether depreciation in the first country leads to competitive depreciation elsewhere.

- foreign currency) as conditioned by the elasticity of foreign supply;
- (2) the *smaller* the elasticity of domestic supply (in terms of domestic currency) as conditioned by the elasticity of domestic demand for these goods;
  - (3) the *smaller* the share of the depreciating country's exports in world supplies.

The third condition is not strictly required, since the depreciating country's importance as a world supplier finds expression, to some extent, in the elasticity of the foreign demand for its exports. If, for instance, the country supplies only a small part of world imports, the demand curve that it faces will be highly elastic. It is useful, however, to add this third condition, because it underlines a feature which is characteristic of the adjustment of prices but not of that of values. In the determination of the *value* of exports, the elasticity of foreign demand and of domestic supply are factors of the same order of importance, even though the depreciating country may be insignificant as a world supplier.<sup>9</sup> In the determination of the *price* of exports, however, the two factors are not of the same order of importance, if the depreciating country supplies only a small portion of world imports. For, in that case, the elasticity of foreign demand is likely to be nearly perfect. Even a very great elasticity of supply will then be insufficient to have a significant influence upon the world price level. Under such circumstances, it is foreign demand that primarily determines the price adjustment, and the elasticity of domestic supply can modify the outcome only within very narrow limits.

#### B. ADJUSTMENT OF IMPORT VALUES AND PRICES

The conditions governing the adjustment of the value and price of imports are analogous to those relating to exports. The

<sup>9</sup> The elasticity of domestic supply becomes ineffective as a determinant of the value of exports only if the elasticity of foreign demand is equal to unity, or zero. In the first case, the value of exports remains constant in terms of foreign currencies, and their value in domestic currency is determined by the degree of depreciation. In the second case, the volume of exports remains unchanged, and hence their value in terms of domestic currency also remains constant.



sole difference is that while changes in the value of exports can only be upwards (in domestic currency), the value of imports may move in either direction, depending on whether the elasticity of domestic demand is greater or smaller than unity.<sup>10</sup> Given an elasticity of more than unity, depreciation will cause a decline in the *value* of imports that will be *greater* (in terms of domestic currency):

- (1) the *greater* the elasticity of domestic demand, as conditioned by the elasticity of domestic supply of the same goods;
- (2) the *greater* the elasticity of foreign supply, as conditioned by the elasticity of foreign demand (in terms of foreign currency).

If the elasticity of domestic demand is less than unity, depreciation will cause an *increase* in the value of imports that will be greater (in terms of domestic currency):

- (1) the *less* the elasticity of domestic demand, as conditioned by that of domestic supply of the same goods;
- (2) the *greater* the elasticity of foreign supply, as conditioned by that of foreign demand (in terms of foreign currency).

As for the adjustment of the *price* of imports, depreciation will cause an increase in import prices that will be *greater* (in terms of domestic currency):

- (1) the *less* the elasticity of domestic demand, as conditioned by the elasticity of domestic supply of the same goods;
- (2) the *greater* the elasticity of foreign supply, as conditioned by the elasticity of foreign demand (in terms of foreign currency);
- (3) the *smaller* the proportion of world exports absorbed by the depreciating country.

As in the case of exports, the elasticity of foreign supply, in the

<sup>10</sup> The possibility that the demand curve for imports might be positively inclined, owing to the existence of a "Giffen effect" for imports as a whole, is so remote that it may be neglected. The conditions for the adjustment of import values could be made fully analogous to that of exports, however, by stating imports in terms of foreign currency. In those terms, their value would always be reduced by depreciation.

sense relevant to the present discussion, is not that of the supply curve for the world as a whole, but that of the curve facing an individual country. If the depreciating country absorbs only a small portion of world exports, the supply curve that it faces is likely to be highly elastic, regardless of the shape of the total supply curve. This elasticity is enhanced by the elasticity of foreign demand for goods in question, to which reference is made in each instance above under the second condition. As in the case of exports, the depreciating country's relative importance as an importer has been included among the determinants of the price adjustment, although it already is reflected in the elasticity of the supply curve that the country faces. The reason again is that while for the adjustment of the value of imports the elasticities of domestic demand and foreign supplies are of the same order of importance, even if the depreciating country is small, the price adjustment under such circumstances is governed almost entirely by the (then nearly perfect) elasticity of foreign supply.

## 2. DEMAND AND SUPPLY CONDITIONS IN THE CASE OF CUBA

The next step is to apply the general conditions laid down above to the specific case of Cuba. Although reference so far has been made only to exports and imports in general, it is clear that a concrete analysis requires an investigation of the demand and supply conditions surrounding individual commodities. With respect to Cuba, this task, which elsewhere might be very extensive, is relatively simple. Cuban exports consist to the extent of roughly 80 per cent of sugar. Hence, a discussion of this staple, with a brief reference to tobacco, is all that in practice is needed to cover the export situation. Cuban imports, on the other hand, consist of a wide range of commodities. This very paucity of domestic sources of supply, however, which is reflected in the multiplicity of imports, facilitates an analysis of the import situation, because it obviously points to an inelastic supply in the short view at least, of domestically produced substitutes for import goods.

## A. THE ELASTICITY OF DEMAND FOR CUBAN SUGAR

The first object of our attention is the elasticity of foreign demand for Cuban sugar, which is governed by three elements: (1) the elasticity of demand for sugar in general, (2) Cuba's importance as a supplier in relation to total supplies, and (3) the elasticity of supply of competing sources.<sup>11</sup> The first point has been the subject of exhaustive studies, which lead to the conclusion that the elasticity of demand for sugar in the United States is in the neighborhood of 0.3.<sup>12</sup> This result probably is not fully valid for other countries, but we may assume that conditions are fairly similar in countries with reasonably high standards of living, and that throughout the world the elasticity of demand for sugar is well below unity.

In considering the second and third points it is necessary to distinguish two historical periods. The earlier one is characterized by relative freedom from quota restrictions, the later one by the introduction of export control in the world market and of import limitations in the United States. We may disregard, as not relevant to a study of past situations when depreciation might have been advisable, the period of the Second World War when these restrictions were temporarily lifted.

A great deal can be, and indeed has been, said about the market for Cuban sugar.<sup>13</sup> Cuba's share in world sugar production has ranged from a high of 25.1 per cent in 1918-19 to a low of 8.1 per cent in 1940-41.<sup>14</sup> As an indication of the elasticity of demand for the Cuban product, however, these figures are deceptive because a large part of the sugar markets of the world has always been completely barred to Cuba by tariff walls. The capacity of the "open" world market for sugar (outside the United States) was estimated at 6 million long tons during the 1920's, and at not much more than 3 million during

<sup>11</sup> As before, all elasticities referred to are price elasticities.

<sup>12</sup> See Henry Schultz, *The Theory and Measurement of Demand* (Chicago, 1938), p. 228.

<sup>13</sup> Guerra, *La Industria Azucarera de Cuba*, Chap. v; Viriato Gutiérrez Valla-dón, *El Problema del Azúcar* (Madrid, 1936); Tariff Commission, *Sugar*, Report to the President of the United States, pp. 41, 64-81.

<sup>14</sup> Farr and Co., *Manual of Sugar Companies* (New York, 1942).

the 1930's.<sup>15</sup> In this market Cuba contributed roughly 15 to 20 per cent of total sales during the 1920's and 25 to 30 per cent during the 1930's. In the United States market, where Cuba enjoys special privileges, the island's contribution has varied from a high of 65.5 per cent in 1925 to a low of 24.6 per cent in 1934. In both markets, therefore, Cuba has been an important and frequently the largest supplier, and her position has been very far from that of an atomistic seller facing a perfectly elastic demand curve.

Since the elasticity of the demand for Cuban sugar is conditioned by the elasticity of competitive supplies, the latter must also be examined. In the world market Cuba's greatest rival has been Java, but competition has been encountered also from European and other countries with exportable surpluses, as well as from the domestic producers of countries that have imported part of their requirements. In the latter countries, the prospect has had to be faced that any reduction in the Cuban supply price, through depreciation or otherwise, would be met with an increase in tariffs. Hence, whatever the elasticity of local supply in these countries, Cuba could not expect to find that the elasticity of demand for her exports to them would be increased by a tendency of local output to shrink in response to a lower Cuban price.

The chances that a lower Cuban price might cause a sharp contraction in Java's output likewise were not particularly good; first, because of Java's lower costs, and second, because the sugar industry, like many others, finds contraction less easy than expansion. Since the production of sugar is not tied to the use of resources of which the supply is limited, the long-run elasticity of supply in the direction of greater output is high. This, however, does not hold true in reverse. The equipment is durable, and the lack of adaptability of the local population in countries like Java bars rapid shifts to more complex types

<sup>15</sup> F. C. Licht, *Monthly Report on Sugar*, May 31, 1934, p. 51; G. Mikusch, "Die Internationale Zuckerkrise und die Versuche zu Ihrer Loesung," *Berichte Ueber Landwirtschaft*, pp. 250-252; G. Mikusch, "Die Schrumpfung des Freien Weltmarktes Wachrend der Letzten Jahre," *Die Deutsche Zuckerindustrie*, May 13, 1933, pp. 418-421, as quoted in Foreign Policy Association, *Problems of the New Cuba*, p. 236.

of cultivation, once the relatively simple habit of cane growing has been acquired. Hence, the long-run elasticity of supply of Cuba's competitors in the direction of lower output is comparatively small. An early reduction in the Cuban price might have forestalled the development of sugar production in Java and elsewhere, but, once it was established, the elasticity of supply of these competitive producers added little to the elasticity of demand for Cuba's output.

In the American market the situation was not entirely analogous, but its net effect, a low elasticity of supplies competing with Cuba, was the same. The output of the off-shore areas, chiefly Puerto Rico, the Philippines, and Hawaii, marketed in the United States was governed by factors similar to those mentioned in connection with Java and Cuba. The elasticity of mainland sugar output (chiefly beet sugar) undoubtedly was greater, since the producers of the agricultural raw material had better opportunities for switching to different crops than the Cuban and Javan farmers. But it was precisely these agricultural interests who carried the greatest weight in the American Congress. Their influence was responsible, in large part, for the increase in sugar duties in the Fordney-McCumber and Smoot-Hawley tariffs. It is not likely that they would have allowed Cuba to strengthen her competitive position without demanding, and securing, further protection. Hence, in the American market, Cuba could not expect to encounter enough elasticity of competitive supplies to make demand for her own product highly elastic. During the 1930's, a new situation developed as a result of increasingly comprehensive marketing controls. Restrictions first appeared in 1928, when Cuba entered into a very limited agreement — which soon broke down — for the curtailment of output with Germany, Czechoslovakia, and Poland. In 1931, the more far-reaching Chadbourne Plan became effective, which embraced 52 per cent of the world's total supply, including about three-fourths of that available for the "open market." When this scheme, too, collapsed, its place was taken by the still more comprehensive International Sugar Agreement, which included the British Empire.

While producers thus were engaged in restricting supply, the

United States, as the largest consumer, introduced import controls, with the same aim of raising prices and aiding domestic and foreign producers. The Jones-Costigan Act of 1934, renewed in modified form in 1937, limited the aggregate amount of sugar to be marketed annually, and assigned quotas to producers in the continental United States, the insular dependencies, and Cuba.<sup>16</sup> Cuba's entire sugar exports thus became subject to quota restrictions — some of her own making, others imposed by the United States. The consequences are obvious: with Cuban exports and foreign purchases limited by quotas, the elasticity of demand (as well as that of supply) became irrelevant for practical purposes. Depreciation thereafter ceased to be capable of exerting a direct influence upon prices abroad. In terms of domestic currency, the Cuban sugar price would rise in proportion to the decline in the currency.<sup>17</sup>

Nevertheless, depreciation in Cuba might still affect the world price in a number of indirect ways. It might induce Cuban producers to alter the timing of their sales, thereby changing the course of prices during the year, and perhaps the yearly average as well. By increasing producers' profit margins, it might put them in a stronger bargaining position to demand larger quotas. It might even induce Cuban producers to abandon the International Agreement. The various world market restriction programs, in fact, might have taken on a completely different aspect, or might never have been instituted at all, had Cuban producers obtained relief through depreciation. The anticipation of such contingencies on the part of buyers might also have influenced the movement of prices. Thus, it would not be quite accurate to say that quota restrictions completely eliminated exchange depreciation as a determinant of Cuban exports and world prices; rather its potential influence ac-

<sup>16</sup> A very minor quota also was set aside for other foreign producers.

<sup>17</sup> From a purely theoretical angle, the price to be determined by an inelastic supply and an inelastic demand, both being fixed by quotas, might appear to be indeterminate within the range given by the degree of exchange depreciation. In fact, however, the competition among importing firms, to whom individual quotas were not assigned, and who were buying from Cuban producers to whom the Cuban government did assign individual quotas, ensured that the price would be on the demand curve, rather than on the supply curve or between the two.

quired an indirect, and probably considerably weaker, character.

During the Second World War, the United States quota system was lifted and the International Sugar Agreement became inoperative. Cuban output came to be dominated largely by bargaining between the United States and Cuba over crop purchases and prices.

#### B. THE ELASTICITY OF SUPPLY OF CUBAN SUGAR

The preceding remarks must suffice for an analysis of the elasticity of foreign demand for Cuban sugar. The next point to be examined is the Cuban elasticity of supply, as conditioned by Cuban demand for sugar. We shall again emphasize elasticity in the direction of higher output, since, for an examination of the effects of depreciation, that is the relevant aspect. It should be remembered, however, that the long-run elasticities of expansion and contraction may differ widely.

In former years, Cuban supply elasticity has been considerable. Witness of this is the rapid expansion from an output of 2,597,000 long tons in 1914 (the highest until then) to 4,000,000 in 1919. The accompanying price rise from 2.64 cents to 5.06 cents per pound seems to have been attributable less to an upward slope of the supply curve than to the upward shift in the whole curve due to the general rise of costs and prices connected with the war. This view is confirmed by a second expansion which culminated in 1925 with an output of 5,189,000 tons, at a price of no more than 2.24 cents per pound.<sup>18</sup>

The assumption of a high elasticity of Cuban sugar supply must be qualified on two counts, however, when the response of output to depreciation is considered. The first potential obstacle to expansion is the upward shift in the cost curve (in terms of

<sup>18</sup> It must be conceded that the price and output of identical years are not particularly good indications of long-run elasticity of supply. The decision to grow additional cane must be made about eighteen months prior to the harvest, and the decision to raise milling capacity perhaps even earlier. Thus the price expectation that calls forth increased output is in good part shaped by the price prevailing eighteen months to two years earlier. The above figures, therefore, must be qualified by adding that in 1923 and 1924 the average price was 5.03 and 3.82 cents per pound, respectively.

pesos) which is likely to result from depreciation. The adverse effects of this shift may be quite pronounced. Nevertheless they could hardly block expansion completely. A similar rise in costs took place during the First World War, but did not markedly impede the rise in production.

The second qualification relates to the willingness of American capital to enter a country whose currency is depreciating, and to seek employment in an industry with a history as checkered as that of cane-sugar production. Cuba has been largely dependent upon American capital, and one of the most important of the reasons why American money during the 1920's and earlier flowed in so readily was Cuba's close tie with the dollar.<sup>19</sup> Even without this insurance, American capital might have moved in, as the example of direct American investments in other Latin American countries shows, provided the profit rate was sufficiently high. But the larger the profits required to attract capital, the less expansion could be expected from depreciation.

Moreover, since the late twenties the market situation of Cuban sugar has rarely appeared sufficiently sound to encourage large-scale additions to productive capacity. Since that time, therefore, the probable reaction of new investment to the stimulus of depreciation has been very uncertain. On the other hand, the milling capacity by that time had become so large as to ensure a high volume of employment in Cuba, whenever the capacity could be fully used. Elasticity of supply, therefore, after the last great plant expansion of the middle twenties, became a matter largely of raising output within the limits of existing milling capacity. It depended upon the willingness to increase the planting of cane, which has always responded very promptly to a betterment in prices. In this sense, it may be said that the elasticity of supply in response to depreciation was high after 1930 as well as before, despite the obstacles to new plant investment.

In the short run — for periods shorter than the growing time of cane — elasticity is governed by the availability of stocks. These may take the form of unsold sugar or of uncut cane from

<sup>19</sup> The Platt Amendment was another and perhaps even more potent factor.



a previous crop. In the direction of contraction, the willingness and ability to accumulate and finance such stocks are the decisive elements.

The elasticity of Cuban demand for her own sugar, which conditions the export supply elasticity, is a negligible factor. Domestic consumption normally is in the neighborhood of 200,000-250,000 tons annually, that is, about 4 per cent of the highest and 10 per cent of the lowest output on record. As such its influence upon export supply can only be small and need not be further examined.

The introduction of the quota system, which has governed total Cuban output as well as the production of each individual mill, has ended any immediate response of output to higher prices. In this sense the elasticity of supply, like that of demand, becomes zero. Again, however, it is clear that depreciation might lead to a modification of the quota system by altering Cuba's competitive and bargaining position.

The elimination of output restrictions during the Second World War has not thrown much light upon the elasticity of supply. The crop-purchase agreements concluded with the United States did not call for maximum output in every year. Moreover, the difficulties of securing new equipment and the abnormality of wartime demand undoubtedly beclouded the picture. Even so, Cuba has shown herself capable of substantial increases in output, but they were less startling than during the First World War, and appear to have remained within the limits of preëxisting capacity.

#### C. DEMAND AND SUPPLY CONDITIONS OF TOBACCO

A few words must be said about Cuban tobacco. This product is a luxury variety of a widely used commodity. As such, it probably faces a highly elastic foreign demand, since a fall in the price of Cuban tobacco would help it to reach a broader group of consumers. For a number of years, however, Cuban tobacco has had to struggle not only against a general down-trend in cigar consumption, but also against rising tariff walls and exchange restrictions. These factors tend to minimize the

favorable effects that a lower price might have. The elasticity of supply of Cuban tobacco is not particularly high, because cultivation of the exportable better grades is tied to special soils, and requires special skills. Domestic consumption, however, is high (roughly one-half of total production), and a price rise in Cuban currency might well cause a decline in domestic consumption and thus lend added elasticity to exports. On the whole, the elasticity of foreign demand probably is greater in the case of tobacco than of sugar. The relative elasticities of supply may be of the same order of magnitude.

#### D. CUBA'S ELASTICITY OF DEMAND FOR IMPORTS

The discussion of the demand and supply conditions surrounding Cuban imports need not be lengthy. In spite of the great variety of imports, the situation is much simpler and more clear-cut than in the case of exports. As to the general conditions of demand it has been observed that Cuba's average propensity to import is among the highest in the world. According to Alienes' estimate, imports, including invisibles, in 1938 amounted to 28 per cent of national income. The range of Cuban imports is correspondingly broad. Not only a great many manufactured articles, but also a good part of Cuba's food supplies come from abroad, as is indicated by the fact that in 1929 foodstuffs amounted to 36.6 per cent of total imports, and in 1940 to 26.8 per cent. Many raw materials for her scanty local industries, as well as the machinery used in the sugar industry, must also be imported. This heavy reliance upon imported goods is true of the lower as well as of the upper income groups, because imported goods in large part are not luxuries but necessities.

All this points to a low price elasticity of Cuban demand for *import* goods, undoubtedly well below unity.<sup>20</sup> Matters might be different if local industries and agriculture were in a position

<sup>20</sup> It should be remembered that only price elasticities are being referred to. A sharp rise in the cost of all imports *unaccompanied* by a rise in money income would also call into play the income elasticity of the demand for imports which would greatly alter the picture. Such a development, however, would not be likely to occur in consequence of exchange depreciation alone.

to offer substitute goods whenever import prices increased. This, however, is not the case. Apart from the highly capitalized and technically very efficient sugar industry, and despite recent industrial gains, Cuba has had and still has only a limited range of industries, producing mainly light consumer goods. Her agricultural activities, too, are concentrated on a relatively limited number of products. Industrial growth has been hampered by the lack of organization, capital, and, last but not least, a sufficient market. Agricultural diversification has been delayed by similar factors, to which fixity of habits and obstacles of soil and climate must be added. It is clear, therefore, that domestic production can substitute for imports only to a minor degree, and that in the short run it does not add very much to the elasticity of Cuban demand for imports.<sup>21</sup> In the longer run, over a number of years, better results might be expected.

#### E. ELASTICITY OF FOREIGN SUPPLY

The inelastic Cuban demand for imports is met, in normal times, by an almost perfectly elastic foreign supply. Ordinarily about two-thirds of Cuban imports have come from the United States, but Cuban purchases rarely have exceeded 6 per cent of total United States exports, and during the 1930's they were closer to 3 per cent. Since exports are only a small fraction of the national product of the United States, exports to Cuba account for only an infinitesimal share of this total. A change in Cuban purchases, therefore, is not likely to have a significant influence upon American prices.

The rest of Cuban purchases are scattered over a wide number of countries, none of which accounted, in peace time, for more than 7 per cent of Cuban imports. Here, too, a change in

<sup>21</sup> The inability of Cuban domestic production to replace imports does not necessarily mean that the elasticity of supply of all home-produced goods is small. The proportionate rise in output following a rise in the price of a given product may be considerable. If the original output, however, is very small in relation to the total amount consumed in Cuba, even a high elasticity of supply would not significantly reduce the need for imports.

imports is unlikely to affect prices.<sup>22</sup> Cuba's position, therefore, approximates that of an atomistic buyer in a large market, for whom the supply curve is perfectly elastic, no matter what the elasticity of supply for the market as a whole may be. The island's powers as a monopsonist are close to zero.

### 3. THE IMPACT OF DEPRECIATION

The foregoing discussion provides a general picture of the demand and supply conditions encountered by Cuba in her international trade. Given these conditions, what would be the concrete effects of exchange depreciation upon the various economic variables that are likely to be influenced by it? Or, put differently, what economic policy objectives might Cuba have effectively pursued by means of exchange depreciation?

There are three broad groups of objectives that depreciation may be designed to accomplish. While all three are apt to enter into any given case, one or the other usually predominates. These objectives are: (1) The general monetary objective of improving the balance of payments in order to protect exchange reserves. This may include an attempt to discourage capital flight. (2) The desire to correct the price-cost structure by reducing pressure upon export prices and upon prices of import-competing industries. In this sense, depreciation signifies relief from deflation. (3) An attempt to stimulate employment, by "exporting unemployment" or protecting domestic industry. At worst, this amounts to a "beggar thy neighbor" policy; on the other hand, depreciation undertaken for such purposes may be a necessary and proper companion measure to a broad program of fiscal and monetary expansion.

While these three objectives overlap in many respects, the basic distinctions of emphasis are clear enough. They can best be dealt with by applying the findings, so far, of this chapter

<sup>22</sup> An exception to this rule is the case where Cuban purchases from a given country are concentrated heavily upon a single product and constitute a major part of the market for that product. Cuban rice imports from Thailand, for instance, have been an important factor in the latter country's economy. Cases of this kind are rare, however, owing to the dispersal of Cuban imports over a wide range of products and suppliers.

to an analysis of the impact of Cuban depreciation upon (a) the balance of payments and the terms of trade, (b) internal prices and the value of debts, and (c) employment and investment.

#### A. BALANCE OF PAYMENTS AND TERMS OF TRADE

The examination of export and import elasticities has indicated that the elasticity of foreign demand for Cuban exports, as conditioned by the elasticity of foreign competitive supplies, has been far from perfect. With regard to the critical question whether it was more or less than unity, the evidence presented does not permit a definitive conclusion. One may suppose, however, that before the establishment of international sugar controls, demand elasticity was more than unity, but probably not by a great margin. Later, under the quota regime, demand became irresponsive to price changes, except in a very indirect sense. On the other hand, the elasticity of supply of Cuban exports, as conditioned by domestic demand for the same goods, we have found to be fairly high. The conclusions to be drawn from these facts are evident: prior to the era of controls, a depreciation of the Cuban exchange rate was likely to cause a fairly pronounced drop in the *price* of exports in terms of foreign currencies. Hence the rise in terms of Cuban currency was likely to be considerably less than proportionate to the degree of depreciation. The *value* of exports, at best, might have risen moderately in terms of foreign currencies, although substantially, of course, in terms of Cuban currency. Under the quota regime, there would have been no change in either the price or the value of sugar exports in terms of foreign currencies, while in terms of Cuban currency both would have risen proportionately to the degree of depreciation. Changes in the price and value of tobacco exports would have been similar to those characteristic of sugar in the precontrol period.

As for imports, the elasticity of Cuban demand, as conditioned by domestic supply, was found to be less than unity. The elasticity of foreign supply is practically perfect. Hence the *price* of imports would remain almost unchanged in terms of foreign currency and would increase in terms of Cuban cur-

rency by almost the full extent of depreciation. The *value* of Cuban imports would decline in terms of foreign currencies, but would rise in terms of Cuban currency.

All in all, the conclusions point toward the probability of a mild improvement in the balance of payments and a pronounced deterioration in the terms of trade in response to depreciation during the precontrol period; and to a somewhat smaller improvement in the balance of payments, without much change in the terms of trade, under the quota regime. As a means of adjusting the balance of payments, and of protecting exchange reserves, therefore, depreciation ordinarily would be only moderately effective in Cuba. Alternative measures, such as exchange control or, preferably, more effective international action to support the price of sugar, would deserve correspondingly greater attention. Somewhat different conclusions as to the effectiveness of depreciation, however, emerge when the main objective is not the correction of the balance of payments but relief from deflation (or from the threat of deflation following a pronounced inflation). This factor will be considered next.

#### B. PRICES OF DOMESTIC GOODS AND THE VALUE OF DEBTS

So far the analysis has dealt predominantly with goods that are exported and imported — that is, with international goods. From these, a series of stages leads to goods and services that are progressively further removed from the international sphere and hence less and less influenced by price changes there. Nevertheless, all goods and services, no matter what their degree of domesticity, are connected with the international set through relations of substitution or complementarity. Moreover, insofar as price changes of international goods are accompanied by income effects — by changing profits and wages in that sphere — there is another and often very strong line of communication to domestic prices.<sup>23</sup> The point at issue is how strongly and

<sup>23</sup> In fact, a very pronounced income change in the international sphere may provoke price changes in domestic goods that are larger than those of international goods, precisely *because* the remoter domestic stages are increasingly less tied to international prices. In the unusual case of a divergent movement of prices and incomes in the international sphere, however, the income effect upon domestic goods would tend to counteract the price effect transmitted by substitution and complementarity.

how rapidly international price changes in Cuba, produced by depreciation, would tend to penetrate to the domestic sphere of the economy.

The pervasiveness of international price changes will depend primarily upon the quantitative importance of the international sector relative to the rest of the economy. Since in Cuba the importance of this sector is very great, the effect of depreciation upon domestic prices is likely to be rapid and thorough. One need think only of the role played by imported commodities in the cost of living and of the large proportion of the labor force employed in the sugar industry. Working in the same direction is the generally greater flexibility of prices in Cuba, which in part is traceable to the lesser role played by administered prices.

In former years the deficient unionization of labor contributed to wage and price flexibility downwards, while the growth of unionism in recent years probably has added to flexibility upwards. Wide fluctuations in the price of capital assets in response to international price changes, moreover, are favored by the narrowness of the market.

To some extent, the impact of depreciation upon prices of domestic goods depends upon the accompanying and immediately preceding circumstances. In the not infrequent case where depreciation is resorted to after an earlier inflation in order to avert a speculative collapse, domestic prices, previously too high, may rise little, relative to the degree of depreciation. The same may happen if the domestic price level had been under pressure from external deflationary forces but had failed to respond owing to stickiness. On the other hand, when depreciation is viewed by the public as a sign of further domestic inflation, or when it is undertaken in the absence of downward pressure on domestic prices, the response of the latter may be quick and sharp. An important factor is the experience that the public may have had with past exchange-rate movements. In countries where these have been frequent, the population usually possesses highly developed protective instincts which enable it to react to depreciation with the same sureness as to changes in the weather. Labor organizations in such countries in par-

ticular tend to watch the exchange rate much as they watch the cost-of-living index elsewhere.

On the whole, one may conclude that in Cuba the reaction of prices of domestic goods to exchange depreciation would be quite substantial under most conditions, although it might be somewhat slow. This conclusion naturally is subject to qualifications in the light of the response of export prices to depreciation. If these fall sharply in terms of foreign currency and hence rise only moderately in terms of domestic currency, as might have been true of sugar prices in the precontrol period, the rise of prices of domestic goods also will be much less.

In either case, the presumed strong tendency of domestic-goods prices to adjust themselves to depreciation will deprive that measure of some of its effectiveness, insofar as it aims at improving the balance of payments.<sup>24</sup> On the other hand, deflationary pressures upon the domestic sector that may have existed prior to depreciation will be relieved by the upward adjustment of prices in that sector in response to depreciation. There may be a divergence of effects upon the various sectors of the economy, depending upon the degree to which domestic goods prices respond, which reflects the basic meaning of depreciation — a process that redistributes among the various sectors of the economy the loss inflicted by a deterioration of its international position.

The power of depreciation to relieve deflation and particularly to ease the burden of debt is of special importance in Cuba, in view of the role that bankruptcy and moratoria have played there. We shall see subsequently how, in the crises of 1920-21 and 1932-1934, a policy of exchange depreciation might have been used to temper the wind to severely shorn debtors, when banks and sugar mills went to the wall and recourse, in desperation, was finally had to an interminable moratorium. At present, we shall merely note how depreciation, through its associated price increases, reduces the real value of various types of debts.

<sup>24</sup> If all domestic-goods prices rose in exact proportion to the degree of depreciation, Cuba would find herself in exactly the position from which she started out.



From the debtor's viewpoint, the important thing is not the price rise in general but the rise that occurs in his particular sphere. A mortgage upon a sugar mill, or on cane-bearing land, becomes less burdensome in accordance with the rise in the value and earning power of such property, which depends, in large part, upon the rise in sugar prices (in terms of Cuban currency). A loan secured by imported merchandise can be repaid more easily the more the prices of these particular products advance. A mortgage upon an apartment house does not become easier to carry unless the price increase in the international sphere is transmitted to the purely domestic one of apartment rents. The general change in the income and wealth of the debtor, of course, has also to be considered.

From the lender's viewpoint, the situation is different. For a foreign lender, who calculates in dollars, the loss from depreciation is exactly proportionate to the decline in the currency.<sup>25</sup> For a Cuban, it may be regarded as equal to the fall in the general purchasing power of money in Cuba. Even here, however, the effect is not uniform. For a *rentier* whose capital is invested in mortgages, the loss is measured by the rise in the cost of living, which might not be the same for various levels of living standards. For a merchant who gives credit to his customers, it is measured by the rise in the prices of the goods in which he deals. If their prices do not change (which might be true of some domestic goods), there is no impairment of working capital and hence, one may say, no significant loss.<sup>26</sup>

Reductions in the value of debts and claims involve, of course, a redistribution of wealth and income. It is important to note that as far as the distribution of wealth is concerned, Cuban exchange depreciation is likely to affect only a small class. The broad masses of the population, who own neither

<sup>25</sup> If the contract is made in foreign currency, it would normally remain unaffected by depreciation.

<sup>26</sup> This may be regarded as a question of opportunity cost. If the alternative to the granting of a loan is to keep the money in a New York bank, beyond the reach of depreciation, the loss may be measured by the decline in the Cuban exchange. If the alternative is a peso deposit in a Havana bank, the true loss equals the price rise in the particular sphere in which the money ultimately is to be employed.

savings deposits nor life insurance nor government securities, would not suffer any loss from their dilution, although the income of these groups might be quite severely affected. Some redistribution between Cuban and foreign interests may result from depreciation or, alternatively, may be forestalled. The latter might have been the case in 1921 if depreciation had been employed to prevent the collapse of the domestic banks and foreclosure upon many Cuban-owned properties.

### C. INCOME AND EMPLOYMENT

We have discussed the impact of depreciation upon the balance of payments and the prices of domestic goods and the effects that might thus be achieved in protecting exchange reserves and relieving deflation. There remains the role of depreciation as a stimulus to income and employment.

In many cases, the desire to protect reserves and to stimulate employment may jointly be responsible for the decision to depreciate. In others, however, the employment motive can be discerned as the dominant one; for instance, if depreciation is undertaken while reserves are still large or while the balance of payments is active or if depreciation is carried beyond the level of an equilibrium rate. Analytically the effect of such depreciation upon income and employment can be treated by the method outlined in the previous chapter, although the finance minister responsible for the decision may not be interested in these academic subtleties. The active balance of payments (or, *mutatis mutandis*, the reduction in the passive balance) that results, stimulates income via the multiplier and acceleration effects and the increase in liquidity. A further incentive to investment results from the protection that depreciation gives to domestic industry. The increase in liquidity resulting from an active balance of payments may be offset, however, by the rise in the price level. If this rise proceeds more rapidly than the creation of new money by the balance of payments, the initial effect of depreciation will be a reduction of liquidity.

Due regard must also be paid to the availability of idle resources. Without these, the effects of depreciation will go almost entirely into prices instead of into real income. Furthermore,

it will depend to some extent upon the degree to which the terms of trade deteriorate whether or not the expansion in money income will signify an increase in real income.<sup>27</sup>

Unless depreciation is accompanied by substantial internal expansion, with a consequent maintenance or even increase in imports, it will be adverse to the interests of other countries. The latter not only will suffer from more intensive competition by the exports of the depreciating country, but will also see their own sales to that country reduced. Such depreciation, therefore, has become unpopular under the name of "beggar thy neighbor" policy, and retaliation has frequently reduced its net effect to a "beggar thy neighbor and thyself" procedure.

But although there is an element of this in almost any type of depreciation, there are clear cases where complaints or retaliation by the neighbors are not in order. The neighbors must remember that a successful deflation, in place of depreciation, will produce exactly the same competitive effects. Deflation, in fact, may reduce the imports of the country that is putting itself through the wringer even further than would depreciation. Complaints are justified, however, if neither depreciation nor deflation are appropriate — that is, when the balance of payments does not require correction or when reserves are still large. Complaints likewise would be in order if a qualitatively appropriate depreciation were carried so far as to make it unduly aggressive. All the conditions under which depreciation is justified can be grouped neatly under the Monetary Fund's broad qualification: "*necessary to correct a fundamental disequilibrium.*"

Still another situation arises if depreciation is employed to set the stage for a policy of fiscal and monetary expansion. In that case, the rise in exports might be matched by a rise in imports. Here the grounds for complaint by other countries shrink to a minimum, although it is still true that certain individual countries may be hurt by the competitive rise in ex-

<sup>27</sup> In this connection it may be observed that if the percentage change in the active or passive margin of the balance is less than the degree of depreciation, the balance may improve in terms of domestic currency while deteriorating in terms of foreign currency, or vice versa.

ports without benefiting directly from the higher imports of the depreciating country. There exist, therefore, a number of cases where depreciation can be employed legitimately to stimulate employment and income, without degenerating into beggar-thy-neighbor tactics.

How might Cuba fare in an attempt to stimulate income and employment through depreciation? In a general sense, the results would depend upon the improvement in the balance of payments. As to this, it has already been seen that only moderate gains could be expected. A clearer picture of the income effects can be obtained, however, by looking directly at exports and imports. In the absence of controls over sugar output, the volume of sugar output, and hence employment in the industry, might rise considerably but only at the expense of declining prices and hence real wages. Under control, there would be no increase in output or employment, yet real wages would probably fall. Imports would decline, but not very sharply, in view of the essential character of many imports and of the lack of domestic substitutes. Thus, the first round of the multiplier and its following stages would not yield very large gains in income. There might be quite a substantial gain from new investment through the acceleration effect, and as a result of the protection afforded by depreciation. On the whole, however, one may conclude that the gains in income and employment that Cuba would stand to realize would not by themselves make depreciation worth while when it was not required for other reasons.

#### D. FURTHER CONSIDERATIONS

The effectiveness of depreciation in achieving its aims depends, in addition to the factors described so far, upon a number of imponderables which are not easily defined. Most of them may conveniently be covered by the familiar catch-all "confidence." If the authorities can convince the business community that depreciation is a step in the right direction and that it will be followed by appropriate fiscal and monetary policies, confidence is likely to be strengthened. If on the other hand, the measure is regarded as a confession of failure, as a

calamity, and as evidence of worse things to come, its potentialities for good may be destroyed, or at least stymied for a considerable period. A great deal depends, in this connection, upon the view that the business community takes of the government. A depreciation by a conservative government is likely to meet with a very different reception than that sponsored by a leftist one.

Important for "confidence," furthermore, is the monetary tradition of a country. In Cuba, where stability has been the rule for many years, the apprehensions produced by depreciation probably would be very much greater than in a country where such things happened frequently. A break with an existing tradition of stability would also have a considerable bearing upon the country's power to attract foreign investment. Although foreign investors probably are more concerned over exchange restrictions than over instability, Cuba's close adherence to dollar parity undoubtedly has been an advantage in this respect. In Cuba's case, therefore, the decision to depreciate would mean the sacrifice of a moral asset which many other countries do not possess and need not consider.

#### 4. WOULD DEPRECIATION HAVE BEEN WORTH WHILE?

So far we have examined on a general level the effects to be expected from a reduction in the value of the Cuban currency and the potentialities of exchange depreciation as an instrument of policy. We must now endeavor to give an answer to the question asked at the outset, whether or not Cuba was wise to maintain virtually stable exchanges throughout each of the three great depressions she has experienced during the last twenty-five years. To this end, it will be necessary to examine the special circumstances of each depression.

##### A. THE ADVANTAGES OF DEPRECIATION IN 1920-21

The outstanding feature of the 1920-21 crisis was not the contraction in business activity, rigorous though that was, but the collapse of the native banks and the passage into foreign hands of numerous sugar properties. It is true that the value of exports dropped sharply, but the *volume* of sugar produc-

tion was fairly well maintained, and in 1923 there was a pronounced recovery. The balance of payments, after 1921, likewise improved. Hence, the advantages that depreciation might have offered as a means of stimulating employment and income almost certainly would not have been worth the disturbance, loss of credit standing, discouragement of direct foreign investment, and other familiar drawbacks.

It might be suggested that depreciation at that time might have helped Cuba to protect her competitive position. By offering her sugar more cheaply she might have discouraged the rapid growth of rival producing areas that began about that time, and which eventually was to deprive her of a large part of her markets. This possibility cannot be denied, but Cuba's competitors did not lack means of defense. Java, the leading rival on the world market, had special advantages of cost and marketing. The United States continental and insular producers possessed political powers which in the event of Cuban depreciation might have secured for them even more protection than was provided by the Fordney-McCumber Tariff. From the competitive angle, therefore, the game of depreciation likewise did not seem worth the candle.<sup>28</sup>

The need for greater industrialization and diversification of output, which Cuba might have attempted to meet by depreciating, was not apparent at the time, and it is doubtful whether the protection provided by depreciation would have been sufficiently effective and sufficiently lasting to have accomplished much in that direction. The mild sugar boom of the middle twenties probably would have wiped out or at least arrested any gains of this sort.

There remains, as a motive for depreciation, the plight of the native banks and the sugar industry. The unhappy results that followed from the disappearance of the banks have been discussed elsewhere. As to the sugar industry, it is unnecessary to emphasize the severity of the blow that Cuba suffered when

<sup>28</sup> This judgment has the unquestionable benefit of hindsight. At the time of the 1920-21 depression, the trends in world sugar production could hardly have been discerned clearly enough to make them a major factor in the formulation of exchange policy.

a substantial number of properties passed into foreign hands at bankruptcy prices. It is not unreasonable to suggest that, if there were no other means of avoiding this twofold calamity, depreciation would not have been too high a price to pay. As a matter of fact, there were two other means of dealing with the situation, neither of them very promising, however. One of them was a large foreign loan, the other a protracted moratorium. The possibilities of a loan to the government, as well as of private loans to save the banks and the sugar industry, were much discussed at the time. The government loan materialized in 1923 but was put to different purposes. The banks and most of the Cuban sugar producers were unable to secure financial support. Even if they had received it, their salvation probably would have been short-lived. Too many bank loans and sugar investments were based upon the exaggerated sugar prices that prevailed during the first half of 1920. When these prices failed to return, the funds that banks and investors had poured into sugar were beyond recovery. There was no organic basis for an emergency loan, and most of its recipients would have found its service and amortization beyond their strength.

A protracted moratorium, likewise, would merely have postponed the day of reckoning, unless it had been so sweeping as to allow debts to sink into oblivion altogether. The unhappy experience with the quasi-permanent moratorium declared in 1933 serves as a warning. Moreover, the banks themselves would have had to be placed under the moratorium, which was not the case in 1933 and which would have created serious problems for their depositors. The brief moratorium of 1920-21, which was more in the nature of a bank holiday, was, of course, no solution for the deep-seated difficulties that existed.

Depreciation, therefore, probably held out the best prospects for a salvation of the banks and the Cuban sugar producers. It would have produced a rise in the price of sugar in terms of Cuban currency and would also have relieved the weight of debts based on other things than sugar. Thus the sugar industry and the banks might have been saved. Whether or not the price of salvation would have been too high depends, in

the last analysis, upon the skill and restraint with which the operation would have been carried out. A moderate and controlled devaluation, not exceeding, say, 50 per cent, with subsequent stabilization, might have been well worth while. Uncontrolled depreciation, ending perhaps in monetary chaos, almost certainly would have done more harm than good.

#### B. OTHER ADVANTAGES IN 1930-1933

The great depression of 1930-1933, of which Cuba began to have a foretaste as early as 1927, presented a very different picture. Its most prominent feature was the enormous shrinkage in the returns from sugar exports, which in 1932 reached a low of 58.4 million dollars. The debt problem, with its attendant danger of wholesale alienation of Cuban properties to the banks, was by no means absent, but did not stand in the immediate foreground. As far as the sugar industry was concerned, bankruptcies were concentrated among the large American-owned corporations, almost all of which went through reorganization. The main problem, therefore, was the stimulation of employment and income.

To that end, a price-support program, if it could have been organized effectively, would undoubtedly have been the best method. Owing to the low price-elasticity of demand for sugar, a restriction in the output or sales of every producer country would have netted each of them a larger return. For Cuba this would have meant a relatively more favorable balance of payments and hence a better maintained level of income and also of employment in the domestic sector. The terms of trade would have been better, and deflation would have been less drastic. Employment in the sugar industry, it is true, would have declined more than without restrictions unless the cut in sales had been compensated by stockpiling of additional output. Given the specific character of much of the labor resources employed in the industry, this would have been a serious handicap. Nevertheless, the more active program of internal expansion that larger exchange receipts would have made possible might have gone some distance toward mitigating the reduction in sugar-industry employment.



An attempt was made, in fact, to bring about a producer agreement to curtail sugar sales in the world market, under the Chadbourne Plan. In the American market, which for Cuba was much the more important one, no such steps were taken on the Cuban side.<sup>29</sup> But apart from this limitation, the Chadbourne Plan had the double weakness that it comprised only part of the producing areas and that it called for a disproportionate sacrifice on the part of Cuba. The nonparticipating producers took advantage of the opportunity to expand their share in the world market, and Cuba had to accept a severe curtailment of output without a corresponding benefit in terms of price. Subsequently, the Chadbourne Plan was replaced by the International Sugar Agreement which did bring together most of the important sellers in the world market. In the American market, profitability was restored by the import quota scheme of the Jones-Costigan Act (1934). By that time, however, Cuba had already suffered extremes of depression and had experienced a painful deterioration of her competitive position, both in the international and in the American market.

Price support, therefore, though intrinsically the best solution, provided only a limited, and under the circumstances a not fully satisfactory, answer. Depreciation consequently might have been considered as an alternative or companion measure. This was the time when most other raw-material countries were depreciating sharply, and for that reason alone Cuban deprecia-

<sup>29</sup> Various methods for raising the American sugar price by artificially restricting Cuban sales to the United States were discussed in Cuba without finding acceptance. One of these, the Gutiérrez Plan, provided for a direct limitation of sales to the United States. Another, the Claret Plan, which reads as if it had been devised by a specialist in Marshallian economics, called for an export tax upon Cuban sugar shipped to the United States. The proceeds of the levy were to be distributed among sugar producers in proportion to their total output, regardless where sold. This would have caused the American price (ex-American tariff) to rise above the world price by the amount of the tariff, for below this level Cuban producers would have had no inducement to sell to the United States, the bonus being independent of the destination of exports. For a discussion of the potential merits of these plans, see Philip G. Wright, *The Cuban Situation and Our Treaty Relations* (Washington, 1931), p. 92. Wright concludes that the expansion of United States domestic and insular output that probably would have resulted from any Cuban attempt to raise the American sugar price, most likely would have spoiled both schemes.

tion would have been psychologically quite understandable. That very substantial advantages would have been realized in the external sphere, however, is far from certain. As an alternative to a commodity agreement, depreciation would have implied a desperate struggle against competitors and against import restrictions, a struggle in which Cuban efforts might have been frustrated in good part by retaliation and ever-rising barriers. It seems likely, nevertheless, that Cuba would have gained at least a temporary competitive advantage, which might also have been of some strategic benefit in the negotiation of commodity agreements and in the competitive struggle for United States marketing quotas.

In 1933-34, Cuba did go through a kind of involuntary depreciation, dragged along by the depreciating United States dollar. That some benefits were realized from this process is quite likely, but they were necessarily modest. In the American market, the most important for Cuba, nothing was gained but what could be realized from the short-lived commodities boom of the summer of 1933, since Cuba's competitors were all in exactly the same position. The internal effects, therefore, also remained small. In the world market, some competitive benefits seem to have accrued; for instance, the very sharp contraction in Java's sugar output, which continued through 1934, may in some degree have been stimulated by the cheapening of Cuban supplies. The time was rather late for such a move, however. The dollar devaluation tended to pull down the entire structure of world prices, and so worked against special gains for Cuba. Many markets had already been irretrievably lost through the tightening net of import restrictions, and further sacrifices in markets had been assumed by Cuba under the earlier Chadbourne Plan. Although the experience seems to reflect rather unfavorably upon what could be achieved in the international market by means of depreciation, it cannot be regarded as conclusive.

In the domestic sphere, the relief from deflation that depreciation would have afforded might have staved off the moratorium law passed in 1933. It was pointed out earlier that this law had to be regarded, in a sense, as an alternative to de-

preciation, and in view of its many adverse consequences one may suggest that it was not a very desirable alternative. Both debtors and creditors might have fared better if, by depreciating, Cuba had succeeded in side-stepping its need.

Finally, depreciation might have freed Cuba for a more active policy of internal expansion. This, however, would have depended in good part on the effect of depreciation upon exchange receipts. If the latter had declined, the gains would not have been great. In any case, they would have been greater if a satisfactory commodity agreement had been in existence; and to achieve full effectiveness, exchange control would also have been necessary.

#### C. FEWER GAINS FROM DEPRECIATION IN 1938-39

The outstanding feature of the 1938-39 depression, like the preceding one, was the contraction of sugar exports. The surrounding circumstances, however, were different. In 1938, Cuba's entire sugar exports were subject to the restrictions of the International Sugar Agreement and of the United States Sugar Act of 1937. Moreover, the fact that, even during the favorable year 1937, Cuba's American and world quotas did not add up to anything like the volume of exports that had prevailed during the 1920's, showed that a permanent change in Cuba's situation as a supplier had taken place. The decline in her exports could no longer be regarded as a cyclical phenomenon, but had to be recognized as a major trend. Hence, the need for a diversification of the Cuban economy, which President Machado had realized as early as 1927, was more pressing than ever.

Exchange depreciation, as a protective device, might have contributed to meeting this need, but not very effectively, and certainly not unless supplemented by other forms of stimulation. Rapid diversification of output would have called for better credit and marketing facilities, which remained neglected. Depreciation undoubtedly would have been less effective than tariff protection, since the protection it could afford was bound to be more or less temporary, coming to an end when costs had caught up with prices.

Nor could depreciation have been expected to lead to a significant rise in exports. Sugar exports were limited by quotas; depreciation, therefore, would have raised the domestic price of the commodity in a like proportion and left exchange receipts unchanged. Tobacco and other products might have benefited, but their contribution was too small to carry much weight.

It is true that depreciation would have permitted further internal stimulation by counteracting the adverse effects of monetary or fiscal expansion upon the balance of payments, but the volume of foreign exchange assets had shrunk so much by 1938 that anticyclical action would have had to remain quite limited. The relief from price pressure that should have followed would also have helped and might even have permitted the liquidation of the moratorium, which certainly would have been a worth-while gain. Apart from this special aspect, however, the internal debt burden had ceased to be a dominant problem by 1938. All in all, therefore, the potential advantages probably would not have been sufficient to warrant a reduction in the value of the currency.

## 5. SUMMARY

The preceding discussion constitutes an attempt, necessarily brief and touching only the main points, to investigate the pros and cons of depreciation during three crucial periods in Cuba's economic history. It was pointed out that the outstanding disaster of the 1920-21 depression was the virtual disappearance of the native banks and the alienation of a substantial number of sugar properties. A comparison of the various means that might have been employed to prevent this calamity showed that depreciation, on the whole, held out better chances of success than either a large foreign loan or a long-term moratorium. Although depreciation was not required so far as the balance of payments or the state of employment was concerned, the need to save the banks and the sugar industry would have sufficed to justify the step.

During the depression of 1930-1933 the case for depreciation was less clear-cut, although on the whole stronger than the case for maintaining stability. Depreciation was a second best,

made advisable by the difficulty of concluding a satisfactory agreement to control the output and price of sugar. It might have been of some value as a means of protecting Cuba's competitive position in the struggle that finally led to the Jones-Costigan Act and the International Sugar Agreement. At the same time, depreciation would have permitted greater fiscal and monetary expansion, would have forestalled many bankruptcies, and would have permitted Cuba to avoid the chain of moratoria.

During the 1938-39 depression, depreciation offered fewer advantages. Cuba's foreign sugar sales had become rigidly limited under well-established stabilization schemes, and there was little prospect of expanding these markets by any means. For the diversification of agriculture and industry, which meanwhile had become Cuba's prime need, depreciation unaccompanied by other more direct measures did not offer much promise.

The most striking thing about these repeated crises is the variety of their central features. Each of them was serious enough to be regarded, in a broad sense, as a fundamental disequilibrium. Nevertheless, the main problems encountered by Cuba on each occasion could not be satisfactorily expressed in terms of balance of payments difficulties or purchasing power disparities, although naturally there were repercussions in these directions.<sup>30</sup> It is evident, therefore, that any attempt to set up a simple criterion of what constitutes a fundamental disequilibrium would fail when confronted with these situations. The desirability of depreciation was to be judged only by weighing the particular circumstances in each case.

The investigation also suggests that exchange depreciation should be viewed, not primarily as one of several alternatives, but as one of a group of complementary measures. The importance of combining depreciation, when it is resorted to, with the proper internal measures has been stressed repeatedly. In

<sup>30</sup> The matter of exchange reserves, which ordinarily would have played a critical role, cannot meaningfully be discussed in the Cuban case, except perhaps with respect to the 1938-39 episode, because of Cuba's peculiar monetary organization.

the external sphere, attention has been directed to commodity agreements and to exchange control, both of which at times may be alternatives, at times complements, to depreciation. The possible advantages and disadvantages of exchange control form the subject of the next chapter.

## CHAPTER XIV

### A CASE FOR EXCHANGE CONTROL?

UP TO THE PRESENT Cuba has had scarcely more than a nodding acquaintance with foreign exchange control. The attempt to establish it in 1934 collapsed within a few weeks; the 1939 legislation,<sup>1</sup> which aimed mainly at procuring cheap dollars for the government and did not involve a licensing system, hardly deserves to be classed as exchange control. The reasons that in the past have accounted for this relative freedom from exchange restrictions have been discussed in Parts II and III. They arose mainly from the technical obstacles presented by the dollar circulation and by the injunction against control embodied in the trade agreement with the United States. With the establishment of an independent monetary system, however, the dollar obstacle is likely to disappear. The injunction in the trade agreement has been made subject to the rulings of the International Monetary Fund. The central bank projects discussed since 1941 all have envisaged the possibility that exchange control may at times become necessary, and the Central Bank Law enacted in 1948 follows them in that respect.

Since the early part of the great depression a majority of Latin American countries have employed foreign exchange control as an instrument of monetary and general economic policy. In most instances, the original legislation was of an emergency character and has since undergone much experimentation and change. In most instances, too, the controls were intended to be temporary and were expected to disappear with the crisis. Like many temporary arrangements, however, Latin American exchange controls have shown themselves remarkably durable. They weathered the prosperity of 1936-37, proved useful once

<sup>1</sup> Stabilization Fund Law, Decree 1358, June 10, 1939, *Gaceta Oficial*, June 15, 1939.

more in the 1938 depression, and were maintained, in form at least, throughout the booming war period. It is true that the vigor of application usually diminished during periods of affluence, sometimes to the extent that exchange was made freely available to all buyers. But the mechanics of control — the concentration of exchange receipts in the hands of the monetary authorities and the licensing of the use of exchange — remained in operation in most countries. In the postwar period, controls once more were vigorously employed in most Latin American countries.

While this tenacious capacity to survive is due partly to administrative inertia and other less desirable aspects, it primarily reflects the fact that the new instrument has shown itself remarkably effective in coping with the problems that tend to beset an export economy. The following are some of the main functions that exchange control has performed: (1) It has proved a powerful instrument of monetary policy for the protection of exchange reserves and the maintenance of exchange rate stability, under conditions where traditional central bank techniques have failed. (2) It has served as a means of regulating foreign trade and of implementing the bilateral obligations willingly or unwillingly assumed by many Latin American countries. (3) It has been employed as an instrument of economic development, through the protection and stimulation that it can provide for growing industries and through the husbanding of exchange resources for development purposes. (4) It has become an important source of revenue for a number of governments and has enabled many of them to exert a greater degree of political and economic control.

We shall now have to study the relevance of each of these aspects to Cuba's position and needs. As in the preceding discussion of exchange depreciation, it will be necessary to look beyond the technical obstacles that so far have made exchange control impossible in Cuba, to a time when its merits and demerits can be weighed objectively. Even so, there will of course always remain technical obstacles of a different character that will make exchange control difficult to execute in practice — such as Cuba's geographical closeness to the United



States, her long coastline, and the intimate relationship between Cuban firms and their correspondents or head offices in the United States. Effective exchange control under such conditions would hardly be possible unless a well-trained and scrupulously honest administrative staff is available.

### I. MONETARY POLICY

In the course of some decades monetary policy throughout the world has gradually shifted its emphasis from external to internal stability. In this process, the balance of payments, which originally had been the chief object of official solicitude, became a secondary element the reactions of which were somewhat grudgingly taken into account as a limiting factor upon the freedom of internal policy. While this shift in economic thinking was taking place, however, several developments occurred which otherwise would have called for increased preoccupation with the balance of payments: (1) the volume of liquid funds (cash and short-term securities) increased considerably; (2) the experience of World War I and its aftermath undermined the belief in the stability of the major currencies as a manifestation almost of natural law; and (3) trade barriers and other rigidities continued to mount. The first and second of these developments served to multiply the volume of potentially hot money, while the third reduced the chances of a quick and easy correction of balance-of-payments disequilibriums on capital or current account.

The logical culmination of these conflicting trends was foreign exchange control. The addition of this powerful weapon to the arsenal of monetary policy made it possible, apart from many other uses, to divorce internal monetary and fiscal action from its external effects. The balance of payments was brought under control by forcibly arresting the mechanism that governed it. The conventional instruments of monetary policy — the discount rate and open market operations — faded into the background of the international picture wherever foreign exchange control appeared.

In Latin America, these conventional techniques taken over from the more developed countries had never acquired much

stature. The rudimentary money and capital markets, with the exception perhaps of that of Argentina, are quite insensitive to their subtle influence. For Latin American countries, moreover, the center of money creation is not the banking system, to which these techniques are addressed, but the balance of payments. It is inevitable, therefore, that a device like exchange control, which attacks the balance of payments directly instead of seeking to influence it via bank credit, should have considerable appeal.

In an investment economy, where the balance of payments is determined in large part by internal conditions, it is logical to seek to correct the balance by working on domestic factors, through the familiar monetary and fiscal instruments. In an export economy like the Cuban, on the other hand, the balance of payments of which is governed mainly by conditions abroad, this is not equally feasible. Even though exchange control often is a cure aimed only at the symptoms of the maladjustment, it may be the best that can be done when the causes are beyond the policymaker's reach.<sup>2</sup>

This generalized view of the matter naturally must be qualified in the light of the inevitable adverse repercussions and of the very considerable technical complications that exist. Usually these speak against exchange control and in favor of the conventional domestic credit controls where they can be applied effectively. It is clear, however, that there is a great difference in the relative need for exchange control in the two types of economies.

Two stages of control must be distinguished: (1) the control of capital movements, now generally regarded as preferable to monetary instability and hence accepted as a respectable, if not wholly innocuous, procedure, and (2) the more dubious device of control over current account transactions. The Monetary Fund permits, in some cases even requires, control of capital movements, while it frowns upon current-transaction control except as an emergency device. There are grounds for thinking,

<sup>2</sup> See Chapter XV for observations on the cyclical conflict between internal and external stability in an export economy and the absence of this conflict in an investment economy.

however, that capital control alone is likely to prove less adequate for countries of Cuba's economic structure than for more mature economies. The emphasis upon capital control derives in good part from the experiences of the 1930's, when hot money movements among the major countries were the most conspicuous international disturbance. The great volume of these movements, however, was made possible only by the high liquidity of the more mature economies, a factor that normally is absent in underdeveloped countries. Major disturbances in the capital balances of the latter have typically come from a cessation of a capital inflow to which they had become adjusted, rather than from an outflow of domestic funds. Prior to the war, certainly, Cuban business and Cuban investors had not attained anything like the state of liquidity that prevailed in the United States and the more important European countries. Of such idle funds as existed, a good part was being held outside the country and did not constitute a threat to monetary stability.

It is true that the relative paucity of potential hot money might imply another kind of threat, if strong incentives to capital flight should appear: outflowing funds would come largely out of active working balances, instead of from idle deposits, and would thus be directly deflationary. The familiar analysis of short-term capital movements, which traces the deflationary effect mainly to changes in bank reserves and interest rates, does not quite fit the Cuban case, where the connection is more direct. As far as the danger of an excessive drain on exchange reserves is concerned, however, the normally smaller volume of funds capable of emigrating indicates that Cuba need fear less from short-term capital movements than more liquid economies. Conversely, the control of capital movements alone strikes less closely at the heart of the Cuban balance-of-payments problem and is less likely to suffice as a safeguard against excessive drains.

With the war came a considerable increase in the volume of idle funds. But since this monetary expansion was due primarily to large exports and to the repatriation of funds induced by the tax upon Cuban investments abroad, rather than to internal

credit expansion, the new idle balances were backed by approximately equivalent exchange resources.<sup>3</sup> A moderate outflow of hot money would therefore have constituted no great danger.

At the same time, the attempt to control capital movements has the distinct disadvantage, for a country like Cuba, of discouraging foreign investment. Argentina and Canada, two countries that have been outstandingly successful in the use of foreign capital, have recognized this in their respective exchange-control practices. In both countries, withdrawal of capital has been permitted to foreigners, at a fluctuating rate, without licensing requirements.<sup>4</sup> The safeguard against excessive drains, in both cases, has been the decline in the rate which would take place whenever the supply of "free" Argentine pesos or Canadian dollars greatly exceeded the demand.

Current account deficits, on the other hand, are more likely to become a serious threat to stability in an export economy like the Cuban than in an investment economy. One reason for this is the cyclical pattern, with its unhappy combination of passive balance and depression. Another is the large size of the current balance of payments in relation to national income. A third aspect, which makes current control seem less undesirable in an export economy than elsewhere, is the relatively large proportion of luxury imports brought about by the highly concentrated distribution of income. An underdeveloped country often can ill afford such imports. Their restraint through exchange control may therefore be regarded as permissible, if other measures are not equally feasible. All this suggests that the distinction between "good" capital controls and "bad" current controls may not be altogether appropriate for an economy of Cuba's structure.

The foregoing relates chiefly to exchange control as a defensive measure, employed to shield the economy against

<sup>3</sup> This was not the case in many other Latin American countries, where intensive internal money creation took place during the war. There, consequently, the abnormal state of high liquidity after the war made capital controls as important as in the maturer economies.

<sup>4</sup> In Argentina, the same privilege was accorded to residents. In recent years, the Argentine system has undergone very substantial modifications.

deflation from abroad. Somewhat different aspects arise when control is viewed as a complement to internally generated expansion. Where such expansion — usually the result of a government deficit — bears no relation to cyclical needs, control becomes merely a screen to hide the consequences of bad fiscal and monetary policy. In that case, action on internal factors instead of on the balance of payments, particularly the current balance, is plainly preferable.

But when internal expansion is called for by an externally imposed depression, the matter is different. Scope for internal action is narrow enough in a country like Cuba, and the additional loss of reserves that compensatory internal expansion superimposes on that which results from the normal cyclical balance-of-payments deficit further limits such action. Without exchange control, this limitation would put Cuba's export economy at a still graver disadvantage compared with an investment economy, whose antideflationary measures can proceed behind the safeguard of an active tendency in the balance of payments. For this reason, too, it is not entirely appropriate to set up the same standards of conduct for the two types of economy. From the viewpoint of anticyclical policy, as well as in the light of the requirements imposed by the monetary structure, the case for exchange control is stronger in the export economy.

## 2. TRADE POLICY

We have seen so far that Cuban exchange control might, under some circumstances, become an important instrument of monetary policy. Next we turn to investigate its potentialities as a means of increasing Cuba's gains from international trade, through an improvement in the terms of trade or through discrimination among suppliers and commodities.

In principle, foreign exchange control can serve to improve the terms of trade by maintaining indefinitely an overvalued rate of exchange. For Cuba, however, such a policy would probably be quite fruitless. A moderate overvaluation of the peso with respect to the level of costs, as mentioned above, will not greatly affect Cuban trade; conversely, it also will

fail to bring about a significant change in the terms of trade. The prices of goods that Cuba imports are determined abroad, and are virtually unaffected by changes in the volume of Cuban purchases. The world price of Cuban sugar exports, it is true, depends partly upon the magnitude of the Cuban supply. This supply, however, can be regulated much more effectively by direct restrictions upon output than through overvaluation of the peso. Only a severe overvaluation, resulting in a very low domestic price, could cause Cuban mills to reduce their production materially; and under the quota regime any failure to fill the aggregate Cuban quota would be compensated by an increase in the sales of other producing countries; no improvement in world sugar prices therefore could be expected under these conditions.

As an instrument of discrimination, on the other hand, exchange control is somewhat more promising, but the net advantages for the most part are not likely to be great, particularly in view of the unfavorable reaction that such practices would encounter in the United States and on the part of the Monetary Fund. Two types of discrimination are relevant to the present discussion: (1) among supplying countries and (2) among commodities.<sup>5</sup> Discrimination among suppliers has always played an important part in Cuba's trade policies. Her entire imports from the United States, almost two-thirds of her total imports in pre-World War II days, enter at the preferential rates determined by the United States Trade Agreement and the supplemental agreements. In 1935, moreover, Cuba adopted a multiple tariff which discriminated sharply against countries with which the balance of trade was particularly unfavorable.

While reciprocity with the United States carries no implication of bilateral balancing of trade, the multiple tariff very distinctly does. In practice, this clumsy device has done little to induce an increase in purchases on the part of the affected countries. It has thus missed its main purpose, which was not to

<sup>5</sup>In addition, exchange control almost inevitably involves discrimination among the broader alternative uses of foreign exchange, such as an accumulation of reserves, payment of interest and dividends, and imports in general, and among firms and individuals applying for exchange.

restrict or shift Cuban imports but to expand the foreign markets of Cuba's languishing sugar industry. Could this aim be achieved through the negotiation of bilateral agreements made effective by exchange control?

A number of the countries with which Cuba has had a permanently passive balance might be willing to permit an increase in their imports from Cuba under such a deal, in preference to seeing their exports cut off. But since only a small portion of Cuba's trade relations offers such possibilities, the gains to be derived from a Schachtian policy could hardly be large, and would probably not warrant the adoption of measures which from an international viewpoint are intrinsically objectionable. A bilateral exchange arrangement with the United States would be of no avail even if the United States were willing to countenance it, which it undoubtedly would not be. The balance of *trade* with the United States is almost invariably favorable to Cuba, and the balance of *payments* undoubtedly is so a good part of the time.<sup>6</sup> An aggressive policy of evening up her passive balances thus holds out little promise to Cuba.

Apart from their lack of positive attraction, there also has been an absence of pressure on Cuba to enter into such bilateral agreements as a means of salvaging existing trade relations. The nature of these relations in the past has protected Cuba from the consequences of a foreign exchange shortage on the part of her customers or herself, a factor that elsewhere has been one of the mainsprings of bilateral agreements. Her two chief customers, the United States and Great Britain, have supplied Cuba with a sufficient amount of convertible exchange to meet her own net obligations to other countries. Some of her other customers, it is true, might have been willing to buy more had Cuba been willing to enter into bilateral clearing arrangements; but these potential markets were limited, and with the excep-

<sup>6</sup> See Tariff Commission, *The Foreign Trade of Latin America* (Washington, 1942), Part II, Vol. II, p. 266. Cuba's balance of *trade* with the United States usually is proportionately more active than her balance with the rest of the world, since the United States accounts for a larger share in Cuban exports than of imports. Most of Cuba's adverse invisible items, however — particularly interest and dividends, as well as capital movements — appear vis-à-vis the United States, so that the balance of *payments* at times becomes passive.

tion of the clearing with Spain, Cuba has never entered into arrangements involving inconvertible balances.

Whether or not these favorable trade relations will continue in the postwar world is somewhat doubtful. Unless the major currencies other than the dollar become convertible, Cuba may have to choose between losing a large part of her sales outside the United States or getting involved in some kind of clearing or blocked-currency arrangement. If the latter alternative prevails, exchange control may have to be used. Control would not strictly be necessary so long as Cuba's normal imports from her partners in bilateralism are sufficient to use up the balances that accrue. But if these purchases must be artificially stimulated to avoid accumulation of large foreign balances, discrimination in favor of the respective partners and against other countries becomes necessary. Exchange control would be the simplest means.

The possibility, therefore, that exchange control as an instrument of trade policy may come to have its uses for Cuba, cannot be denied. That it would be employed more in a defensive than an aggressive capacity, likewise seems fairly clear, but its inherently undesirable international and domestic repercussions would not be removed thereby. Cuba probably would be well advised to avoid bilateral entanglements, unless the sacrifice involved in such avoidance was very substantial.

There remains the possibility of employing exchange control to discriminate, not among countries, but among commodities. This might be done either to stimulate domestic industries, a subject that will be taken up in the next section, or to reduce exchange expenditures on unessential goods and services. It was pointed out above that in relatively poor countries, where a highly unequal income distribution stimulates luxury imports, a good case can be made for the restriction of such imports. When exchange resources are scarce, this case becomes very strong. Exchange control is one of the most flexible means of effecting the necessary degree of restriction. The drawback, however, which it shares with other forms of quantitative import limitation, is that it creates windfall profits for importers. The reduced supply drives up the price in the local market,



while the cost to importers remains unchanged, with the result that profit margins are widened. It may therefore be desirable to combine control with a system of special exchange rates or similar devices which would absorb the windfall profits by increasing the cost of merchandise to the importer.

Much the same effects in curtailing luxury imports can be achieved, however, by means of import quotas. Hence, if there is no call for exchange controls in the light of other considerations, this special use alone would hardly justify its introduction.

### 3. RESOURCE DEVELOPMENT AND INDUSTRIALIZATION

Discussions of exchange control frequently proceed on the assumption that the resources and the technological advancement of the countries concerned are given data and not themselves functionally related to foreign exchange control. On this basis one arrives almost inevitably at the conclusion that while individual nations, under favorable circumstances, may benefit from control, the world as a whole is bound to lose.

The assumption of constant resources and skills, however, while quite justifiable in dealing with mature countries, bypasses what for undeveloped countries is perhaps the center of the problem. The need for more rapid development of resources and particularly for more intensive industrialization has been brought home to Cuba and other Latin American countries by the difficulties experienced with exports during the thirties and with imports during the war. In practically all of these countries, "development" programs are among the chief governmental preoccupations.

There are various ways in which exchange control can be made to serve these needs. One way is to give preferential exchange rates to export industries by restraining the importation of competing goods through the licensing system or through unfavorable rates. Another, much talked about at the end of the war, is the diversion of exchange resources from consumption imports to imports of capital equipment. Finally, domestic industries using foreign raw materials can be subsidized by favorable exchange rates and liberal allocation of exchange.

Most of these devices are forms of subsidization which raise the inevitable question as to the economic merits of the industries that are their beneficiaries. Part of the answer is, of course, that the risks involved in living by exports are so great that a country may rationally prefer to live modestly in relative economic security rather than lead the glamorous but uncertain existence of an international commodity speculator. Another and more satisfactory answer, however, is that in an undeveloped country, the much abused "young industry" argument has a good deal of validity. There, lack of technical skills and organization is a real problem; a partly illiterate agricultural population must be converted to new tasks, and managerial and engineering talent must be developed on a wholly new scale. The difficulties of this process and the rewards in social and economic terms make protection appear in a more favorable light than in maturer countries.

On the other hand, it is no secret that the penchant of Latin American entrepreneurs for monopolistic practices may prevent the "young industries" from ever reaching the point where they stand on their own feet. In that case, as was pointed out in Chapter I, industrialization redounds largely to the benefit of the few. Unfortunately, exchange control as an instrument of protection lends itself peculiarly to the dispensation of special privileges. Its operation is administrative, rather than legislative, and little exposed to the public view. Frequently its protective implications are not easily demonstrable and it can play havoc with international tariff agreements. This is one reason why it seems preferable to dispense desirable protection as much as possible in other forms, through tariffs or direct subsidies. Another reason is that the administrative character of foreign exchange control makes the protection it provides rather less certain and permanent than that provided by tariffs. The effectiveness of exchange control in stimulating new ventures is probably smaller therefore than that of tariffs.

This, however, does not apply to the use of exchange control to divert resources to imports of capital equipment, and particularly to its use for conserving the large cyclical exchange

accumulations against dissipation through consumption. Most Latin American countries had made this their stated policy at the end of the war, although the indifferent success achieved by many suggests that the policy is easier to announce than to implement. Cuba's exchange accumulation during and after the war was very substantial, and the country was fortunate in not seeing this fund vanish during the early postwar period. In a way, these resources offer Cuba a unique opportunity. It would certainly be very unfortunate if they were frittered away in capital flight and consumption imports.

Possibly the danger that this opportunity would otherwise be lost constitutes a valid argument for the institution of exchange control, even where there are no other factors calling for it. But before so far-reaching a step can be advocated, several questions must be answered. One is the administration of the controls, for the difficulties of effective administration are very great. A second question is how large a volume of private and public investment can reasonably be expected. There is a limit to the amount of physical capital that can be pumped into a young economy within a given period of time, owing to the relative lack of trained labor and industrial organization, and because of the inflationary repercussions. Cuban exchange reserves may well be so far in excess of any conceivable volume of proximate investment, by the time the sugar boom comes to an end, that a rigid economy in their use may be not particularly urgent. This possibility would be enhanced if there should be good prospects for loans from international lending agencies at that time.

Another and broader question which must give pause to advocates of exchange control is the effect that it is likely to have upon direct foreign investment. Control keeps domestic capital from flowing out, but it likewise discourages foreign capital from coming in. Besides barring the entry of foreign capital it also prevents the importation of technical skills, which usually accompanies direct foreign investment. It is this type of investment that Cuba particularly needs for the building up of a wide range of light industries. The days of large-scale foreign investment along the lines of the sugar industry may be over in Cuba,

but there is increasing scope for more moderate-sized enterprises, as the island develops and its internal markets expand. Foreign investors will be reluctant to make such commitments unless adequate assurance exists that profits can be transferred home.

This assurance cannot be provided by legislation alone, but must rest upon the general record and reputation of a country and its government. Cuba's reputation as a relatively attractive country for foreign capital, which has been established over many years, is an asset which should not be sacrificed lightly. It is possible, of course, to create an exchange control system that permits the repatriation of profits, but the existence of control in general, and the ever-present possibility of sudden change, are not things to inspire the confidence of foreign investors. The virtual absence of exchange control, so far, gives Cuba a stake in the continued maintenance of free exchanges, unlike countries which have had control for some time and which, in some instances, already have acquired a dubious reputation as regards their manner of dealing with foreign capital.<sup>7</sup>

#### 4. FISCAL ASPECTS

The fiscal importance of foreign exchange control in Latin American countries, and potentially in Cuba, derives mainly from the exchange profits that can be garnered through differential buying and selling rates or through a tax on foreign exchange transactions. Profits from exchange control have been an important source of revenue at various times for a number of Latin American countries. The mild control that Cuba introduced in 1939 likewise had as its primary aim the procurement of cheap foreign exchange for the government.<sup>8</sup>

These revenues are little more than a tax upon foreign trade.

<sup>7</sup> It must be observed, however, that the attraction to foreign capital that lies in the absence of exchange control may easily be nullified if other policies are adverse to investment. A pronounced partiality to the demands of labor, for instance, which many observers have noted since 1944, might have this effect. Decisions regarding exchange control must naturally be taken in the light of over-all economic policy.

<sup>8</sup> See page 212n.

They could equally well be collected by means of an explicit levy upon exports or imports,<sup>9</sup> and from a purely economic point of view one therefore cannot regard the need for revenue as a relevant motive for imposing or maintaining control. It is only from the viewpoint of practical politics that these levies may have something to recommend them, as many a harassed finance minister can testify who has taken refuge in such devices when an increase in other forms of taxation has seemed impractical. The vested interest in the continuation of exchange control that the government thus acquires, however, is clearly undesirable.

But although foreign exchange profits cannot be regarded as a valid motive for introducing or maintaining exchange control, they need not be rejected by the government if control has been established for other reasons. They are a perfectly legitimate means of absorbing the windfall profits that might otherwise accrue to importers whenever the volume of imports is significantly restricted by exchange control. They become objectionable only if they continue to be collected after the need to conserve exchange resources has disappeared. To minimize the danger that the government might acquire a vested interest in exchange profits — a very real danger in Cuba — they might be devoted to extraordinary purposes, such as redemption of the floating debt. It is to be noted, however, that any withholding of such profits from the income stream, like all taxes that are not respent, is a deflationary factor.

## 5. FOREIGN REPERCUSSIONS

The effect of Cuban exchange control upon her foreign trade is not a purely Cuban affair, but a matter of legitimate concern for her trading partners as well. It is true that Cuba is a small country with only a minor share in the total of world trade, and that her trade policies therefore have less influence on the pattern of world trade than those of the large countries. Neverthe-

<sup>9</sup> Foreign exchange profits provide an interesting illustration of the dictum that a tariff on exports does not differ in principle from one on imports. Depending on whether one chooses to regard the central bank's buying or its selling rate as *the* exchange rate, the levy becomes the equivalent of an import or export tariff.

less, by adhering to the International Monetary Fund, Cuba has expressed her desire to collaborate in outlawing the jungle tactics that dominated much of international trade during the thirties. Even though the Bretton Woods obligations are sufficiently flexible during the transition period to permit almost any kind of exchange policy, Cuba for reasons of material interest as well as moral obligation must look beyond the immediate advantages of exchange control to its ultimate repercussions upon world trade. In this sense, Cuba is in the same position as a small firm joining in a price-maintenance agreement which thereby assumes a greater responsibility for pricing policies in its industry than belongs to it by mere virtue of its output.<sup>10</sup>

It is important to note, therefore, that the disruptive effect that Cuban exchange control and the consequent inconvertibility of the Cuban peso might have upon world trade is likely to be much less, proportionately, than Cuba's share in world trade, and therefore very small indeed. This is due to the fact that Cuba belongs to that great majority of countries whose foreign trade is typically conducted not in their own currency but in that of one or more of the great trading countries — in what has come to be called a key currency. In Cuba's case the bulk of her exports, as well as her imports, is invoiced and paid for in dollars. There is no reason to expect that the future elimination of the dollar from the internal sphere would in any way affect the predominance of this key currency in Cuba's foreign trade.

When a key country imposes exchange control and thus limits

<sup>10</sup> It is one of the curious contradictions of economics that we do not adopt the same standard of judgment in dealing with the tariff and exchange policy of a trading country as with the price policy of a firm, although both represent the same problem of interdependence among members of a competing group. We expect the atomistic firm to cut its price to the competitive level, but to the atomistic country we preach the virtue of self-restraint in the interest of the group. Unless it has a reason to expect that its own policy will materially influence that of others, the small trading country has no motive to abstain from restrictive policies that it regards as advantageous in an immediate sense. Since Cuba does have an important share of world trade in certain commodities, she is not altogether without influence upon the trade policies of the rest of the world, but her influence and hence her responsibility are very minor compared to those of the United States and Great Britain.

the convertibility of its currency, it thereby deals a blow to multilateral trade the severity of which far exceeds the quantitative importance of the country's foreign trade. Its currency now ceases to be a universally acceptable means of international payment,<sup>11</sup> and the scope for multilateral dealings is correspondingly reduced.<sup>12</sup> Frozen balances now begin to accumulate in the hands of the exporters, banks, or central banks of the "export" countries that have an active trade balance with the key country. This makes it incumbent upon the authorities of those countries or of the key country to initiate steps toward the liquidation of the balances. The key country may institute some kind of bilateral arrangement, under which part, if not all, of its imports must be balanced through exports to the export country. This would force the latter to find a means of increasing its imports from the key country in order to balance its trade upwards, under penalty of seeing it balanced downwards if its efforts do not avail. Alternatively, the export country may of its own accord take steps to stimulate imports from the key country in order to disencumber its central bank or private interests of their frozen exchange holdings and reduce its international creditor position.

In either case the export country may find it necessary to establish a foreign exchange control of its own, as the easiest means of controlling the source of its imports and of effecting such discrimination against other suppliers as becomes necessary. By one route or another, therefore, inconvertibility of a key currency almost inevitably leads to discrimination and bilateralism, and very likely to a spreading of control to some of the export countries.

<sup>11</sup> The term "universally acceptable means of international payment," as used here, does not imply that any international invoice can be paid in that currency, but that its holder can, at practically no cost or inconvenience, acquire with it the particular currency he needs. It is true, of course, that any currency that is freely convertible can be used to acquire any other currency, but in practice only a few currencies — mainly the dollar, the pound, the Dutch guilder, the French and Swiss francs, and, before 1931, the reichsmark — have been internationally significant.

<sup>12</sup> If all key currencies are inconvertible, multilateral trade remains possible only insofar as blocked balances eventually can be liquidated through gold shipments or multilateral clearing.

Some, of course, of the supplying countries, and particularly the key countries, will demand payment in a currency that continues to be convertible. This, however, constitutes another motive for the exchange control country to work toward the establishment of bilateral clearings, since that country probably will encounter difficulties in supplying the free exchange demanded. Insofar as multilateral dealings are continued, their volume is likely to be reduced.

Inconvertibility of the currency of an export country is not nearly so contagious, in fact much less so than in proportion to its bargaining power and economic weight. This is due, in good measure, to the fact that such control does not interfere directly with the mechanics of international payments, since it does not reduce the range of universally acceptable currencies and does not give rise to holdings of blocked local currency in the hands of foreign exporters or central banks. Individual foreign exporters no doubt may experience payment delays, if the volume of imports exceeds exchange availabilities, but these unpaid balances do not exert the same pressure toward bilateralism or toward establishment of foreign exchange control in the supplying country as emanates from inconvertibility of a key currency. Since they are usually denominated in the exporter's own currency, they do not carry the implicit suggestion for the exchange control country that they might be liquidated through an increase in local purchases by the other country. For the latter, they are not so much an exchange problem as one of private credit, since in the absence of foreign exchange control they do not come under official purview and are not an immediate object of official policy. In this respect they do not differ greatly from unpaid domestic bills. As an involuntary capital export, they do, of course, constitute a balance-of-payments problem, but for a key country, which normally is an exporter of capital, this does not present so grave a difficulty as for a secondary country. Exchange control by an export country, in brief, while it tends to reduce trade, is much less inimical to multilateralism than if exercised by a key country.<sup>13</sup>

<sup>13</sup> An important factor in a key country's lesser susceptibility to exchange control abroad is, of course, its usually superior size and economic weight.



There are other reasons why key-country exchange control is more contagious and hence more disruptive than that of export countries. Once a key country has enmeshed a series of export countries in its control system, it becomes very difficult for the latter to break away, particularly if the key country uses its control to maintain an overvalued exchange rate. In that case the discrepancy prevailing in the key country between the internal and world price levels is likely to spread to the export countries, weakening their relations with the world market and making them more dependent upon the key country. An export country is not in a position to cast a similar spell over a key country, owing to its lesser economic weight, and also because the frequently greater price flexibility of its exports (usually raw material) tends to prevent overvaluation through foreign exchange control.

All this serves to confirm the general impression that the international repercussions of Cuban exchange control would be relatively minor, as far as their effect upon multilateral trade is concerned. Another special factor present in the particular case of Cuba is that the bulk of Cuba's foreign exchange receipts accrue from sales to the United States and are paid in United States dollars, a currency the convertibility of which seems assured. Exchange control in Cuba, therefore, if imposed would probably reflect an over-all shortage of international means of payments rather than a shortage of any particular currency. Even under control, Cuba could pay in convertible currency whatever obligations she was able to pay, and would not have to endeavor to get her trade partners to accept some third currency, of lesser convertibility, such as sterling.

## 6. CONCLUSIONS

The preceding survey of the potential uses that Cuba may make of exchange control shows that only the monetary policy function holds out substantial promise. As a means of conserv-

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This advantage would tend to disappear, however, if a large number of secondary countries imposed exchange control. The main point is that a key country is more immune to contagion by the exchange control of other countries because it deals predominantly in its own currency.

ing exchange resources in bad times and thereby facilitating compensatory domestic policies, exchange control can become extremely important. This approach would emphasize the importance of control of capital movements, but would not be limited to this aspect. At the same time, this approach would limit the duration of effective application of control to periods of balance-of-payments difficulties and would thus restrain the growth of the administrative evils usually connected with it, although the mechanism as such might have to be retained permanently on a *pro forma* basis once it had been employed for the first time.

As for the other potential functions of control, their usefulness to Cuba is doubtful both because of the small positive results to be expected and because of their harmful repercussions. An aggressive trade policy, using exchange control to discriminate among supplier countries, is not practicable owing to Cuba's trade structure. There is a danger, rather, that bilateral agreements of this kind will be forced upon Cuba by her trade partners against her will. Discrimination among commodities may be useful in some respects, but can be easily carried out by means other than exchange control. Control for the purpose of development is of dubious merit, insofar as it is employed to protect young industries, since better means are available. As a means of conserving exchange resources for the same purpose, its attractiveness is greater, but the adverse repercussions upon foreign investment must be borne in mind. The fiscal gains from exchange control, finally, while tempting, involve the serious danger of creating a vested fiscal interest in a levy involving an undue burden of "friction" for the economy. In addition to its small intrinsic merit, the use of exchange control for trade policy, development, or government revenue has the failing that it calls for the permanently instead of temporarily effective application of such measures. This unquestionably would intensify the administrative evils and permit the growth of cumulative maladjustments.

The great danger in distinguishing between the monetary policy function of exchange control, which is "good," and the other three functions, which are probably "bad," is that a tem-

porary control established for the good purpose may be perverted and perpetuated to serve the bad. It would probably be futile, however, to suggest that in order to forestall this danger, the monetary policy instrument should be laid aside altogether. Rather, Cuba should make use of exchange control to help overcome temporary monetary problems whenever the need arises, and trust to good sense and to the vigilance of the International Monetary Fund to keep her from going beyond the conservative confines of this policy.

## CHAPTER XV

### CENTRAL BANKING PRINCIPLES IN AN EXPORT ECONOMY<sup>1</sup>

THE SHAPE OF THE MONETARY EVENTS discussed in the preceding chapters had been influenced, to a steadily increasing degree, by the absence of a central bank. The expansion of the peso currency made the creation of some kind of regulatory instrument more and more urgent. This was recognized by the Constitution of 1940, Article 280 of which provides that:

Money and banking shall be subject to regulation and control by the Nation. The Nation shall, through the medium of autonomous entities, organize a banking system for the best development of its economy, and shall found a National Bank of Cuba, which shall be a bank of issue and rediscount. On establishing said bank, the Nation can require that its capital be subscribed by the banks existing in the national territory. Those which fulfill these requisites shall be represented on the Board of Directors.<sup>2</sup>

Soon after the adoption of the Constitution, Cuba began to experience a large active balance of payments, which reëmphasized the need for a mechanism of control, and which also facilitated its creation by providing Cuba with large exchange reserves.

#### I. REASONS FOR ABSENCE OF A CENTRAL BANK

Various reasons may be cited why Cuba, after the establishment of an independent republic, remained without a bank of issue. The island still preserved unpleasant recollections of

<sup>1</sup> A Spanish version of this chapter has appeared, under the title of "La Banca Central en una Economía de Exportación: el Proyecto Cubano," in *El Trimestre Económico* (Mexico), XIV, No. 2 (July-September 1947), 244.

<sup>2</sup> *Gaceta Oficial*, July 8, 1940.

the inflation produced by the note issues of the Banco Español, with which the Spanish government financed the wars of 1868-1878 and 1895-1898. These memories undoubtedly prejudiced many Cubans against a central bank. Business interests, particularly those of foreigners, always preferred the existing American dollar currency to other arrangements and strongly opposed attempts at monetary reorganization. In 1923, for instance, plans for a central bank were side-tracked through the establishment of the Federal Reserve agencies. In 1934, new plans for monetary reform had to be dropped owing at least in part to business opposition. Since it could not be denied, in the last analysis, that the dollar was in many ways a very satisfactory currency, Cuba might have gone along indefinitely without a monetary system of her own.

During the depression of the thirties, however, Cuba found it necessary to consume part of her dollar reserves and to support the budget by issuing pesos. As a result, she found herself sitting on two monetary chairs, without being comfortable on either. To go back to a pure dollar system would have required a large and burdensome foreign loan or a very great budgetary effort, until the fiduciary element could be squeezed out of the peso currency. The logical course, therefore, was to move forward toward the establishment of a well-organized independent currency with an adequate regulatory mechanism.

There was no lack of proposals designed to accomplish this end. The great majority of them proposed the establishment of a central bank, ranging in character from the ultraconservative to the hyperinflationary. None of these schemes was ever voted upon by the Cuban legislature, although a number did get as far as the congressional committee rooms. The project put forward in 1942 by the American Technical Mission to Cuba gave a new orientation to central bank planning.<sup>3</sup> A series of law projects, all based to some extent upon that of the Technical Mission, eventuated, and after long discussions a central bank law was finally passed in December 1948.<sup>4</sup>

<sup>3</sup> *Federal Reserve Bulletin*, August 1942, pp. 774-801.

<sup>4</sup> Law No. 13 of December 23, 1948; *Gaceta Oficial*, Edición Extraordinaria, No. XXIV, December 30, 1948.

This legislation, which in addition to the central bank law proper contains provisions regulating the currency and the operations of the private banks, is on the whole more conservative in character than most of the projects which preceded it. Its outstanding features are: (1) control of the bank by the government, with a minority representation for the private banks; (2) prohibition of loans to the public; (3) severe limitation of direct loans to the government; (4) implicit provision for the financing of temporarily unsalable sugar surpluses through nine-months rediscounts; (5) provision for the establishment of exchange control with the concurrence of the executive power; and (6) requirement to maintain the exchange rate at par *only* with respect to exports and essential imports, thus in effect permitting multiple exchange rates. Through provision for unlimited open market operations in government securities outstanding for one year or longer, and for the financing of an official agricultural bank (to be established later), the possibility of by-passing some of the more restrictive provisions was left open.

## 2. WHAT TYPE OF INSTITUTION?

The central bank law is sufficiently flexible, and the prospect for its eventual liberalization under the pressure of economic events sufficiently strong, to support the view that the nature and success of its operations will be a function more of its policies than of its basic law. More fruitful, therefore, than a discussion of the details of this law, will be a general discussion of the broad structure and functions of a central bank in an economy like the Cuban.

This discussion draws heavily upon a body of ideas that began to develop during the thirties among economists interested in the Latin American scene. These ideas are the product of many minds, but their logical synthesis, their application in practice, and their legislative systematization were the work chiefly of Raúl Prebisch and Robert Triffin, the former as manager of the Argentine Central Bank from 1935 to 1943, the latter as author of the central bank legislation of Paraguay

in 1944.<sup>5</sup> Their work, as well as that of Dr. Herman Max of Chile, has been prominent in molding the progress of central banking through and technique in Latin America.

To begin with, we shall have to say a few words about the form of the regulatory institution that might have been selected for Cuba. The arguments for and against a Cuban central bank have generally revolved around the question whether an institution with the broad powers characteristic of modern central banks would be preferable to a more limited mechanism, such as a conversion fund.<sup>6</sup> This debate now has been decided in favor of an institution with broad powers. It is interesting, nevertheless, to investigate whether, in principle, it was advantageous to organize the new institution in the form of a central bank, or whether the same functions might more conveniently have been assigned to a different type of organization.

It may cogently be argued that central banks as such have outlived their basic *raison d'être* and that their functions, which remain of unquestioned importance, could better be performed by a differently organized institution. Central banks, with their note-issue monopoly and supposedly rigid subjection to gold-standard rules, were long the means by which a liberal age attempted and at times succeeded in taking away from the government the power to create money. Through the double safeguard of private control and of giving the institution the char-

<sup>5</sup> See Raúl Prebisch, in *El Patrón Oro y la Vulnerabilidad Económica de Nuestros Países* (El Colegio de México, *Jornadas*, No. 11, 1944), and "Observaciones sobre los Planes Monetarios Internacionales," *El Trimestre Económico*, July-September 1944, pp. 185-208. Also Robert Triffin, "Central Banking and Monetary Management in Latin America," in *Economic Problems of Latin America*, ed. Harris, and "Monetary Developments in Latin America," *Federal Reserve Bulletin*, XXXI (June 1945), 519-530, and *Monetary and Banking Reform in Paraguay* (published by the Board of Governors of the Federal Reserve System, Washington, 1946). Some expression of similar trends of thought can also be discerned in the central bank legislation and operations of Canada, South Africa, and New Zealand, described by A. F. W. Plumptre in *Central Banking in the British Dominions* (Toronto, 1940), as well as in the Commonwealth Bank Act of 1945 governing the operations of the Commonwealth Bank of Australia.

<sup>6</sup> The late Professor Graham, in 1934, argued for a conversion fund and against a central bank. Since that time, however, the increasing importance of the peso currency probably has weakened the case for such an arrangement. See Foreign Policy Association, *Problems of the New Cuba*, pp. 329-341.

acter of a bank, with its liquidity and solvency requirements, a highly conservative policy appeared to be ensured. While no one questioned that central banking was strongly affected with the public interest, the attitude that central banks before the First World War took toward liquidity and solvency risks was very much that of a private business.

The last and perhaps most deliberate expressions of this philosophy were the central banks established by the late Edwin Kemmerer in various Latin American countries. Since the start of the Great Depression, however, the barriers which this philosophy had sought to erect against government intervention in the field of money and credit have been broken down more and more. It is probably fair to say that at present governments are as firmly entrenched in this sphere as they were during mercantilist days. Central banks, *de jure* or *de facto*, have become government agencies and carry out the policies formulated by the political authorities. It is true that many of the outward trappings of their old autonomous splendor still remain. Now, however, these have become sources of weakness rather than of strength, encumbrances that prevent many central banks from having a voice in governmental affairs appropriate to the importance of their functions and that in some respects interfere with the most effective execution of such functions. A newly created central bank will inevitably find itself burdened with many of these inherited handicaps, and it will therefore be worth while to scrutinize them in some detail.

There can be little doubt about the subordinate position that central banks in general now occupy within the hierarchy of their governments, particularly vis-à-vis the treasuries. To some extent this is a result of the historical process — victorious governments are determined to maintain control over the monetary territory they have just conquered. A second factor is that the stock of monetary policy has sunk very low, owing to the disillusionment that followed upon the high hopes of the twenties, although in Latin American countries this is perhaps less the case than elsewhere. In the third place, many central banks are handicapped by the fact that, through capital participation or through the composition of their directorate,



they still seem to be partly representative of private interests. This is apt to keep the head of the bank from being fully accepted as a member of the official family, no matter how completely the bank actually is under the thumb of the government. Vis-à-vis the treasury, finally, a central bank's position is inherently weak, because governments usually are more immediately concerned with having money to spend than with controlling the effects of it.

In some measure, these handicaps can be overcome through choice of high-grade personnel and through the gradual building up of an independent tradition within the government. Particularly, a newly created central bank, starting out enthusiastically and unencumbered by lethargy and inertia, is in an excellent position to attract first-class talent and to become a center of advanced economic thought in government circles. The Central Bank of Argentina has been an example of this.

There remains one handicap, however, which flows from the very structure of a central bank and which therefore is hard to overcome. It is the familiar fact that, as a bank, the central institution must keep up at least the pretense of solvency, and is thereby barred from a number of operations that are of interest to it but cannot be undertaken because of their risk or expense. One need only think of public lending operations and similar government promotional activities with their possibilities of large losses, and of open market sales of central bank obligations or increases in the international value of the currency, with their high interest costs and book losses on exchange reserves, respectively. These and other functions and operations fall into the field of monetary policy; they should therefore be under the control of the central bank and should be employed actively when the occasion demands it. But as the central bank ordinarily cannot bear heavy costs or assume substantial risks, these functions are apt to be employed hesitantly or not at all, or left to be handled by another agency.

In the latter case, if it is a matter of financing something or other, the chances are that the other agency will get the necessary funds from the central bank, particularly in Latin Amer-

ican countries, where other sources of funds are hard to tap. The central bank then holds government securities instead of whatever risk assets arise out of the operation in question, and is seemingly well protected. From the viewpoint of liquidity — that is its ability to contract the money supply<sup>7</sup> — however, it is almost as irretrievably involved in the operation as if it had acted for its own account. Central banks the world over today are full of government securities that they cannot sell. While these may be safe enough, as far as the credit risk is concerned, their lack of salability makes the central bank quite as illiquid and the increase in the money supply quite as permanent as if the bank had become tied up with frozen business credits.

All that the central bank gains is an apparent solvency of its assets, although even this is *au fond* purely nominal. Most central banks, unlike well-run commercial banks, could not be liquidated with something left over for the owners, if by liquidation we mean the collection of their loans and the disposal of their securities portfolio in the open market, nor is it of primary importance whether they are solvent in this sense or not. The traditions and legal requirements of banking oblige central banks, nevertheless, to strive for this nominal solvency and freedom from risk, and they are therefore forced to surrender control of many operations of a distinctly monetary nature to other government agencies. In other instances, desirable operations must be omitted altogether for the same reasons. To add insult to injury, a central bank frequently will be held responsible by the public for the monetary consequences of operations conducted by other agencies and financed reluctantly by the bank.

This familiar dilemma could be overcome if central banks could find the courage to be guided only by the monetary and other public-interest consequences of their operations and to disregard the impact upon the balance sheet. Most central banks, however, are not likely thus to disregard the “business” aspects of their operations. They are and remain banks which

<sup>7</sup> This is the only sense in which one may speak meaningfully of central bank liquidity.

must be seemingly liquid and solvent and hence are subject to the inherent limitations of public confidence and their own psychology.

The functional solution — once the liberal ideal of a truly autonomous central bank has been given up — probably would be to convert these institutions into government-operated funds or agencies, without any of the connotations of a bank. These funds would have the functions and purposes of central banks but would not be limited by earnings considerations and credit risks. They could thus perform directly many operations with monetary-policy implications that central banks now finance but dare not handle directly. Such operations could range from relatively safe emergency credits for business enterprises to more hazardous but economically desirable promotional activities. Whenever necessary, the institutions also could supply funds to the government, through their issue power, without the subterfuge of purchasing “marketable” government securities. They might, at the same time, be given control of the financing decisions now usually made by treasuries, insofar as these have important monetary implications. These would include decisions affecting the structure and rate pattern of the public debt and the degree to which new money creation should be indulged in for government financing.

Some few central banks today seem to be moving in the direction of such purely functional operations, knowingly or otherwise. Some, too, have obtained sufficient control over other governmental credit institutions to ensure that the timing and volume of the latter's operations do not interfere with central bank policy, which certainly constitutes a long step toward the functional ideal. In general, however, central bank practice and public opinion, even in mature countries, continues to cling to traditional notions. Most people are “slaves of some defunct economist,” as Keynes put it, and are far from prepared to accept the substance of present-day monetary management without the trappings. In countries like Cuba, in fact, where periodic currency issues by the government have been the rule, the public seems to be skeptical even of perfectly commonplace central bank operations. This applies particularly to the auto-

matic issue of currency resulting from the acquisition of assets. There seems to be a tendency to regard such increases in central bank money, even when resulting from an inflow of foreign exchange, as something that ought to remain subject to special authorization in each case, preferably with a maximum limit upon the aggregate issue. A public troubled by such doubts may have some difficulty in adjusting its thinking even to a central bank of the traditional type, let alone an institution of the functional type described above.

Since popular confidence in the monetary system is a *sine qua non* of successful monetary management, the degree to which monetary institutions can follow the suggestions of advanced reasoning is limited by what the public will accept. An institution that operates in so delicate a medium as money obviously must sacrifice the advantages of superior organization to the need of placating its environment. Hence the answer to what kind of institution would best be suited to Cuban monetary needs is that a central bank of traditional and conservative character seems to represent the maximum that should be attempted at present.

These conclusions are further supported by considerations arising out of the nature of the civil service systems of many underdeveloped countries, among them the Cuban. Central banks have traditionally enjoyed the advantage of a stable staff, unaffected by political changes. They have thus been able to develop a continuity of viewpoint that would be impossible in an agency where even relatively minor jobs change hands with every political reversal. This is borne out by the phenomenon frequently observed in Latin America of the central bank's establishing itself as the defender of long-term viewpoints vis-à-vis the frequently short-term viewpoints espoused by the government. Central banks, furthermore, with their more stable personnel and their usually higher pay scales, have generally been able to maintain the high standards of business conduct normally associated with banks and this has to some extent fortified their position in the community. The Cuban central bank law follows these traditions by establishing exceptionally stringent requirements for the selection of its personnel.

### 3. FUNCTIONS OF THE BANK

Every country views its central bank in terms of its own particular problems. This naturally is true also of the hopes and fears entertained by Cubans with respect to their own recently established institution. In general, a survey of Cuban press comments during the years 1941-1947 leaves the impression that the Cuban central bank was being looked upon, not so much as a mechanism for monetary regulation, but as an engine for credit creation. In view of the absence of organized money and capital markets, and of the shortage of other than commercial credit facilities, that is hardly surprising. According to their particular point of view, some of the proposed bank's supporters appeared to think of it primarily as a means of giving more liquidity to bank portfolios, or as an aid to industrial or agricultural financing, or as a potential lender to the government. The opponents of the project, forming what seems to have been a minority, formulated their objections along much the same lines — emphasizing the dangers that might be inherent in any of these functions.

In the following survey of the functions of a Cuban central bank, we shall have to take due note of these special viewpoints. Primarily, however, we shall have to deal with its general monetary-policy functions, in the expectation that the bank will strive for general monetary control — despite the handicaps imposed by the condition of the money and capital markets — and that it will try to develop these media in which it must operate to a higher point of efficiency.

The operations that the central bank may usefully perform fall into three main groups: (1) exchange regulation, (2) control of the money and credit supply, and (3) special financing operations. After discussing these, we shall conclude with a brief survey of the principles which should govern the bank's business cycle policy.

### 4. EXCHANGE REGULATION

In the field of foreign exchange regulation, two major functions are open to the central bank: (a) stabilization of the

exchange rate and (b) control over exchange transactions. The first needs to be done under all circumstances, although not necessarily at a permanently fixed rate. The second is an emergency measure which should not be resorted to except under considerable pressure. Once adopted, however, the latter becomes a monetary weapon of great strength and should be integrated with the bulk of the bank's monetary powers.

#### A. EXCHANGE RATE STABILIZATION

Cuba never has had an adequate instrument for maintaining the exchange value of the peso, at par or at any other rate. The stabilization fund created in 1939 was wholly insufficient, and the stabilizing functions entrusted to the Treasury in 1945<sup>8</sup> were neither broad enough in scope nor sufficiently clearly defined to protect the peso rate in case of a substantial movement in the balance of payments. The central bank will be the first Cuban agency to do this job in the manner long practiced in other countries.<sup>9</sup>

The main problem connected with this function is not, of course, its technique, which is simply the unlimited purchase and sale of gold or exchange at fixed prices, but the form and degree in which the bank is allowed to vary this rate. The general aspects of exchange rate variation in the Cuban economy were discussed in Chapter XIII, where it was concluded that in the past Cuba could have benefited from devaluation probably only at very rare and exceptional moments. Nevertheless, such circumstances may arise again, and this possibility is explicitly recognized by the International Monetary Fund. Is it

<sup>8</sup> Decree 407, *Gaceta Oficial*, February 15, 1945.

<sup>9</sup> The central bank law places rather exaggerated emphasis on the setting up of a stabilization fund outside the central bank. Such a separate fund was originally proposed by the American Technical Mission mainly for the purpose of facilitating the sterilization of exchange inflows in the manner of the British Exchange Equalization Account. The fund was to finance its exchange purchases through sale of certificates. Its independent character was to prevent the interest cost from falling on the central bank, whose earnings seemed rather uncertain, and allowed this cost to be charged directly to the government. The subsequent evolution of the project, however, has tended to exalt the position of the stabilization fund far beyond the largely routine character of its functions.

advantageous to empower the bank by administrative decision to take such far-reaching action?

Administrative decision has the advantage of permitting quick action, if and when the critical moment comes. Quick action is essential in such matters, for protracted legislative discussion would lead to unbearable uncertainties and speculation that even a tight exchange control could not altogether prevent. Moreover, the most likely consequence of a protracted public discussion in the face of dwindling exchange reserves would be, not a stubborn defense of the existing rate through the sacrifice of the bank's last resources, but some form of emergency action by the bank, leading to inadequately controlled depreciation rather than to deliberate devaluation. Despite the advantages of administrative action, however, it might be preferable, in a country accustomed to exchange stability and where the local currency has only recently overcome its initial handicaps, to have somewhat stronger barriers to exchange manipulation than solely the restraint of an administrative agency. For this reason, if legislative approval of exchange rate variations is not feasible because of the loss of time involved, the responsibility could conveniently be shared between the executive branch of the government and the bank, instead of resting with the latter alone. This is, in fact, the solution adopted by the new law.

To ensure maximum efficiency in its rate-stabilizing function, the bank must endeavor to concentrate in its hands as much of the exchange resources of the country as possible. The first steps in this direction might be the absorption of the dollar bills in circulation and the eventual conversion of the silver reserve into usable exchange. A further step would be the concentration of the commercial banks' dollar holdings, with due regard for the latter's need to balance their own exchange position. The maintenance of the 0.15 per cent monthly tax on Cuban investments abroad would work in the same direction. The final step, and one that need not be taken unless the need becomes pressing, would be the control of capital movements and of nonbank balances abroad.

## B. EXCHANGE CONTROL

Although in some countries exchange control is not administered by the central bank, there are good reasons why it should be. Exchange control, in its unadulterated and most defensible form, is essentially a monetary instrument. It is complementary to other monetary policies, especially to compensatory expansion in depressions. Its purpose is, or should be, to permit the central bank to fulfill its obligation of stabilizing the exchange rate. The allocation of scarce exchange resources among different applicants, to be sure, is not an organic central bank function and could well be performed by some other agency. Nevertheless, even here a central bank may have a distinct advantage, owing to its somewhat greater immunity to the pressures of private interests, as well as because of its usually high standards of competence and honesty — qualities which any exchange control administration stands very much in need of.

The usefulness of exchange control for Cuba (discussed in Chapter XIV) probably would be that of a temporary and emergency device rather than of a permanent institution. If we accept the thesis that in a deepening crisis, as reserves shrink, exchange control should be tried before resort is had to the *ultima ratio* of depreciation,<sup>10</sup> we must admit also that a greater degree of administrative discretion should prevail for the former than for the latter. The central bank, in other words, should have a certain degree of freedom in deciding on the timing and the character of the controls.

Unfortunately, the unique monetary experience of the late thirties has made it difficult for the Cuban public to distinguish clearly between exchange rate *stabilization* and exchange *control*. The operation of the stabilization fund created in 1939 was, in fact, a form of exchange control. It is said by Cuban economists that this has tended to create the impression that stabilization necessarily involves some degree of control over exchange transactions. The central bank could demonstrate

<sup>10</sup> Unless the crisis can be diagnosed from the outset as one due to a fundamental disequilibrium — which would probably be a rare case.



very easily that this is not the case. Nevertheless, there is likely to remain a residual propensity toward control even under conditions of relative ease. Under stress, this propensity is apt to be enhanced by the Cuban tradition of approximate exchange stability, which will tend to weight the choice between control and depreciation in favor of the former. The net result may be that in the bank's own policies exchange control will figure more prominently, and the possibility of rate variation less prominently, than these two alternatives respectively deserve.

### 5. CONTROL OF MONEY AND CREDIT SUPPLY

Practically all operations performed by a central bank have the effect of increasing or reducing its monetary liabilities. They similarly increase or reduce the total money supply, or at least the reserves of the banking system. But not all such central bank operations are performed for the deliberate purpose of altering the money supply. In the case of exchange purchases and sales, for instance, or of loans to the government, this effect is incidental to the primary purposes of, respectively, maintaining exchange stability and covering a deficit. Here we shall be concerned only with operations carried out specifically to influence the money supply and the volume and use of credit.

The central bank will have to undertake such operations whenever monetary conditions or other factors threaten to produce an unwholesome expansion or contraction. In the Cuban economy, there are three major sources whence such disturbances are likely to originate: (1) the balance of payments; (2) the commercial banks; (3) the government, when it runs a deficit.<sup>11</sup> An active or passive balance of payments will increase or reduce incomes and prices, expand and contract the volume of money, and affect both the demand and supply of bank credit; changes in commercial bank credit, whether or not accompanied by balance of payments disturbances, will

<sup>11</sup> This breakdown of sources of disturbances is not intended to parallel the analysis of strategic forces in Chapter XII. We are dealing here with concrete central bank policies, and must therefore concentrate upon institutional more than upon economic distinctions.

have the same effect; a government deficit, which under prevailing conditions would have to be financed largely by the central bank itself, would likewise expand the money supply unless timed so as merely to offset a shrinkage produced by the other factors.

The specific corrective action which the central bank may have to take would in part depend upon the origin of the disturbance. A curtailment of bank credit, for instance, might be the appropriate means in case of speculative excesses, but not necessarily the means for dealing with an inflation produced primarily by the balance of payments. Likewise, open market sales might help to restrain a balance-of-payments boom, but might not be feasible at a time when the government had exhausted the capital market and was drawing on the central bank. However, since the character and effectiveness of such corrective measures are better discussed in terms of the institutions and people at whom they are aimed rather than in terms of the sources of the disturbance to be corrected, we shall here survey them as they are applied to the commercial banks, to sellers of foreign exchange, and to the public at large.

#### A. BANKS

How strong are the monetary powers which the central bank can bring to bear upon the credit policies of its member banks? The bank will dispose of an impressive array of devices to influence commercial bank reserves — primarily open market operations, advances and rediscounts, and changes in reserve requirements. Nevertheless, their effectiveness, particularly in producing expansion, is apt to be relatively limited vis-à-vis the preponderant sector of the banking system consisting of the foreign and some of the older domestic banks. These banks have shown little inclination to expand merely because they had idle funds on hand. They have preferred to hold these in the form of dollar balances in the United States or, for tax reasons, in the form of excess reserves in Cuba. An increase in reserves produced by central bank expansion is not likely to induce them to increase their lending substantially. Likewise,

while excess reserves remain at the levels reached during and after the war, the central bank would find it hard to restrain these banks if they should elect to expand.

With regard to some of the newer domestic banks, the central bank's powers are apt to be more effective, since these banks have shown a distinct tendency to put all their available funds to work. In fact, the mere establishment of a central bank may be the cause of considerable expansion in this sector, since the banks would feel safer in using excess reserves previously held for emergencies. Thus, the effectiveness of central bank action may in part depend upon the distribution of resources among the older, more conservative banks and the newer, more aggressive banks — a distribution that at the end of 1947 continued to be heavily in favor of the former group.

The bank's power, however, particularly in the direction of contraction, may grow in time as the high excess reserves piled up during the war are worked off. In the direction of expansion, the bank's greatest usefulness may turn out to be its ability to prevent forced liquidation of loans when a passive balance of payments is drawing reserves out of the banks.<sup>12</sup> In addition, the central bank should be able to develop some qualitative controls to supplement its quantitative measures and so make up in part for what the latter may be lacking in strength.

#### B. SELLERS OF FOREIGN EXCHANGE

Against the monetization of a heavy exchange inflow resulting from an active balance of payments, the central bank can take several measures which would serve to keep down the money supply and bank reserves. One of these would be to impose controls on the import of capital.<sup>13</sup> Another would be to encourage the holding of balances abroad by exporters and others by inducing the government to remove taxes on such holdings and by eliminating other obstacles.<sup>14</sup> An outright re-

<sup>12</sup> Even the foreign banks, which in most Latin American countries try to avoid rediscounting, might do so under such circumstances since the exchange risk would probably prevent them from drawing on their head offices.

<sup>13</sup> Cf. the measures taken in this direction by Argentina, Colombia, and Uruguay to protect themselves against the wartime capital inflow.

<sup>14</sup> Cf. the observations in Chapter X on the inflationary effect of the tax on foreign balances, which put pressure on their holders to repatriate.

fusal to buy foreign exchange would not be feasible, of course, since it would tend to drive the peso to a premium;<sup>15</sup> a possible alternative, however, might be to require certain exporters to cover part of their peso needs by borrowing pesos in the market instead of by selling dollars to the central bank, provided this did not give rise to the creation of additional bank credit.<sup>16</sup> The most potent weapon of this kind is to require exporters to invest part of their proceeds in "stabilization certificates" of the central bank or in other securities.<sup>17</sup> When deflation strikes, the reversal of these measures, *mutatis mutandis*, gives the central bank a means of compensatory action.

But how important are the effects that can be hoped for, in either direction? The inflation-curbing power of the measures outlined depends of course on the intensity with which they are applied, particularly in the case of the forced sale of stabilization certificates. But this device, like the others, finds its limits in the harmful secondary effects that it produces. If the certificates are made negotiable, many exporters will sell them at a discount, thereby demoralizing the securities market. If they are nonnegotiable, which would seem advisable, they will bear very heavily upon firms that are relatively less liquid and are making relatively moderate profits. This limits the proportion of export proceeds that the central bank can sterilize without running into very intense resistance. Moreover, the sterilization of these funds does not necessarily always represent a corresponding absorption of income into saving. The exporter may have idle funds which he can mobilize, or he may borrow; in either case the effectiveness of the measure would be greatly reduced.

### C. THE GENERAL PUBLIC

The foregoing indicates the difficulties which the central bank is likely to encounter in trying to make its credit policy

<sup>15</sup> This, for instance, was the result of the policy followed by the Swiss National Bank during the war in regard to foreign exchange of certain origin.

<sup>16</sup> This device was employed, with rather indifferent success, by the Central Bank of Venezuela vis-à-vis the foreign oil companies.

<sup>17</sup> This measure was employed by the Colombian Bank of the Republic during the war and proved very effective. It is also provided for in the central bank legislation adopted by Paraguay in 1944.

effective by working on the banks and on sellers of exchange. The credit operations which it may conduct directly with the public therefore acquire a special significance. Open market operations, of course, would be the simplest approach, but the undeveloped state of the Cuban securities market and the scarcity of internal government securities give the bank very little scope in this respect. Hence, to make its influence felt directly, the bank either would have to engage in direct lending to the public, or else would require full policy control over the operations of some other government bank or lending agency. The need for contact of this kind, if central bank policy is to be made effective, is well recognized.<sup>18</sup> The principle is implicit in the structure of some of the older Latin American quasi-central banks, such as the Bank of Brazil and the Bank of the Republic of Uruguay, and has become explicit in the central banking structure of Costa Rica, Nicaragua, and Paraguay.

The original project of the American Technical Mission proposed the creation of various official credit institutions and also suggested that the bank be given power to lend to the public under emergency conditions. The latter proposal became one of the most controversial of the entire project, because some circles evidently feared that its implementation might not only create severe competition for the private banks, but might open the door to unsound lending practices and credit inflation. The proposal was retained in some of the subsequent projects, but eliminated in the law as finally enacted. Since the sole official credit institution provided for in the law — the agricultural bank — remains to be created, the central bank in effect will have less direct contact with the market than is usually thought desirable for effective monetary control. There is a possibility, consequently, that the bank may be left “hanging in the air” as far as the implementation of its policy is concerned, until and unless the agricultural bank is set up, or until a good market for government securities or for those of the stabilization fund develops. Nevertheless, this danger is smaller perhaps in Cuba than it might be elsewhere, in view of the growth of the domes-

<sup>18</sup> See Plumptre, *Central Banking in the British Dominions*, pp. 65, 97, 152, 425

tic sector of the banking system, the operations of which may to some extent depend upon central bank credit.

Related considerations apply to the other point of contact between the bank's credit functions and the public — open market operations. The lack of widely held internal government securities, and the correspondingly undeveloped state of the securities market, as said before, greatly limits the effectiveness of the instrument. The bank could operate with its own obligations, of course (or with those of the stabilization fund), but the chances are that whatever funds could be absorbed by their sale would have remained largely idle anyway. The absorption of funds which otherwise would have become active would be much more difficult, because central bank obligations at reasonable interest rates could scarcely compete with high-yielding mortgages or business ventures. *Vis-à-vis* the banks, open market operations might be more effective than with the public, because many bank loans carry rates not above what the central bank could afford to pay. Nevertheless, it is far from certain that the central bank could create a real tightness in the money market by selling its obligations to the banks. The banks might merely put marginal funds into such investments without on that account ever turning away loan applicants.

The repurchase of its own obligations by the bank might have considerable expansionary effects, if the bank previously had succeeded in selling a sufficient amount of them. But since this latter process has its limits, the bank would eventually depend for open market material upon the meager supply of government bonds.<sup>19</sup> Such a situation might easily promote the use, or misuse, of open market operations for straight government financing, for the coincidence in a depression of the government's need for credit and the bank's willingness to buy

<sup>19</sup> Of the bonds in the hands of the Cuban public, by far the larger part are external dollar bonds repatriated in recent years. The purchase of dollar bonds by the central bank against pesos would pose for the sellers the rather interesting question of whether to reinvest in another dollar asset. If they did this, and purchased dollars for the purpose, the bank might experience an immediate drain upon its reserves as a result of its open market purchases, and the intended expansion of the money supply would be nugatory to that extent.

bonds could well prove irresistible. This has been the history of open market operations in many Latin American countries and, during the war, also in the United States. Although the law provides that regular open market operations can only be conducted in securities outstanding for one year or longer, it would not be difficult to find legal means of circumventing the intent of this provision. In view of this, one may well ask whether it might not be better to give up the pretense that open market operations are unconnected with governmental financing and instead to include all purchases of government bonds under such limitations as may be placed upon direct loans to the government.

#### 6. THE CENTRAL BANK AS A DEVELOPMENTAL AGENCY

To readers accustomed to the peaceful ways of traditional central banking, the thought of a central bank engaging in developmental or promotional work may be slightly disquieting. But each country, as noted before, views its central bank in terms of its own needs. In an underdeveloped country the accent will naturally fall upon developmental activities, partly because of the urgent need for them and partly because the economic structure usually does not allow the bank very much scope for its regulatory activities.

This does not mean, of course, that the central bank should engage in large-scale financing of numerous new enterprises. In Cuba, with her limited elasticity of domestic production and her high propensity to import, such action ultimately would be bound to lead to inflation, accompanied by depreciation or permanent exchange control. Nor should this proposed role of the central bank be taken as implicit support for the theory now popular among some Latin American economists that central bank inflation, because of the forced savings it creates, is the best means of industrializing a country suffering from inadequate capital formation. This theory certainly is contradicted by past experience, as well as present observation, both of which seem to show that, while in the short run there may be favorable effects — just as a country at war may increase its

war effort by permitting moderate inflation — in the long run anything but a very slight price rise is likely to have adverse effects upon sound capital formation.

Nevertheless, while the central bank cannot pull capital out of a hat, it can, in times of less than full activity, inject life into would-be savings that otherwise would have been stillborn and condemned to cause contraction in the economy. Within the limits of the voluntary savings that tend to arise in the economy and that otherwise would not be offset by investment, the central bank may extend credit for the purpose even of long-term investment. Even so, its expansionary action is limited by the repercussions upon the balance of payments. Also, it must consider the danger that the additional money supply may create trouble later when exports or privately financed activity pick up again.

Perhaps equally important with the bank's ability to finance certain developmental activities is its function as a planner and organizer. A new central bank, with first-class personnel and aided by the hopes and expectations of the community, is in a position to become the focus of policy and to carry through projects that have often been thought of but never realized. It can develop a highly trained staff whose members gradually pass into key positions in other parts of the economy and of the government. It can do broader educational work to raise the general level of economic understanding.

We shall discuss the three main fields in which the central bank may engage in fruitful developmental work: (a) commercial banking facilities, (b) special financing institutions, and (c) securities markets and government credit.

#### A. COMMERCIAL BANKING

The domestic Cuban bankers have been acutely aware of the competitive advantage enjoyed by the foreign banks by virtue of their being able to fall back upon their head offices. Lacking this moral and material support, the domestic banks must carry substantial excess reserves and are nevertheless hard put to gain the confidence of the public. Their disadvan-



tageous position has resulted in large measure from the absence of a central bank.

The central bank therefore would have as one of its developmental tasks the stimulation and expansion of domestic Cuban banking. This would provide credit facilities for some sectors of the Cuban economy which in the past, partly because of their remoteness from foreign trade, did not get as much attention from the foreign banks as they deserve. The growth of domestic Cuban banking would have its advantages even for the foreign banks, since it would shelter them somewhat against the political consequences of their own bigness and alien nationality.

It would be unfortunate, of course, if the creation of the central bank should turn out to be the signal for a mushroom expansion of anorganic banking facilities. If right at the start some of the existing domestic banks should attempt to lend out most of their excess reserves, relying upon the rediscount facilities of the central bank, they would inject a considerable amount of inflationary fuel. High initial reserve requirements fixed by the central bank might be a remedy. An attempt by some banks to expand with the direct use of central bank funds would be even more dangerous, and would have to be checked by a firm monetary policy, unless business conditions meanwhile had made compensatory action desirable. The establishment of new banks, which would be greatly facilitated by the existence of a central bank and which in principle would be entirely desirable, could not with impunity be allowed to degenerate into an overnight expansion of shoestring banks, of a kind not unfamiliar in Cuba in boom times.

To strengthen its own controls and to protect the Cuban public, the central bank needs the support of a good banking law. This, in turn, requires a competent bank examination system. While the banking law passed as part of the central bank legislation leaves something to be desired, the legislation does appear to provide the facilities required for proper bank examination, the effectiveness of which is increased because the supervisory authority is entrusted to the central bank itself.

## B. SPECIAL CREDIT INSTITUTIONS

More than commercial banking facilities, which, except for some blind spots, are on the whole adequate, Cuba needs agricultural and industrial credit. The long neglect of the financing needs of practically all crops except sugar cane has left Cuban agricultural credit at an impasse from which no casual or haphazard efforts can free it. Present financing methods involve a pyramiding of charges, in some cases amounting to exploitation, the grower being financed by the local storekeeper, the storekeeper by the merchant who supplies him and simultaneously buys the produce, and the merchant, in turn, by the large wholesaler. This system has produced human and material conditions that in many cases do not provide the necessary legal and financial bases for bank credit. What is needed is a special agricultural bank which, by means of painstaking detail work, will gradually create the conditions for safe lending.

Cuba also stands in need of an industrial financing institution. As in the case of an agricultural bank, the mere offer of credit facilities is not enough; the institution would also have to do educational and organizational work. To speed up the development of the country and to direct it into the most promising channels, the sometimes lagging efforts of private enterprise could profitably be supplemented by those of an agency along the lines of Mexico's *Nacional Financiera*, resembling in some respects the American Reconstruction Finance Corporation. Such an institution would not only grant short- and long-term credit to industry, but at times would also join in the promotion of new ventures, temporarily accepting stock participation.

The central bank, likewise could benefit from the existence of such institutions. Through them the bank could intensify its qualitative credit control and, more important, could achieve the close contact with the market which it needs for effective monetary policy. It is essential, of course, that the central bank should have adequate control over the policies of these lending institutions. Partial purse-string control, through the power to refuse rediscounts, would perhaps not be enough; the bank

ought to be able to issue specific policy directives regulating the rate and limits of expansion or contraction. Otherwise there is the danger, even the probability, that the aims of the development banks would often be at cross purposes with those of the central bank, in which case monetary stability would be the most likely victim.

### C. GOVERNMENT SECURITIES MARKET

The third major field of endeavor which invites the attention of the Cuban central bank is the task of building a good government securities market. At the present time, there are neither securities nor a market, except for some trading which goes on in the Cuban government's dollar bonds originally floated in New York and since repatriated.<sup>20</sup> This situation has constituted a considerable handicap in the past, and its correction would promise even greater advantages for the future. In addition to the larger scope which a good market would offer for fiscal policy, it would also provide an instrument for central bank policy, and would in some measure protect the bank against the demands of the government, by offering an alternative and healthier source of funds. In addition, a good market for government securities would help the private securities markets, whose development in turn would attract and stimulate savings, bring down interest rates, and gradually take the financing of new enterprises out of the exclusive hands of small groups.

Various more or less deeply rooted obstacles have so far prevented the development of a good government securities market, but the experience of Argentina, for instance, shows that these obstacles can in good part be overcome by an aggressive central bank, if reasonably favored by circumstances. Among the factors which in the past seem to have prejudiced the Cuban investor against such securities may be mentioned (1)

<sup>20</sup> There is also a domestic bond issue of which, at the end of 1945, a little over 7 million pesos were outstanding; this came into being, however, not through flotation in the market, but in payment of an old floating debt. The existing floating debt of the government, estimated at 70 million pesos, is not in negotiable form. Moreover, in the words of a prominent Cuban banker, the floating debt is in effect "sunk."

their relatively low yield compared to that of business investment and mortgages, (2) lack of confidence, (3) fear of monetary instability, (4) insufficient marketability, and (5) traditional preference for real estate investment and the consequent inertia vis-à-vis a novel instrument.

What can the central bank do to remove these obstacles? To improve the competitive position of government securities, it can work toward lower rates on other types of loans and investments. This action will be greatly facilitated if the bank can count on the assistance of one or more official lending institutions. It can further add to the attractiveness of government securities if it establishes favorable conditions for their use as collateral for central bank credit.

The need for investor confidence could perhaps be met, if necessary, by substituting the central bank's own credit for that of the government. The central bank could issue its own obligations in the form of participation certificates in the government securities which it owns. Experience in some countries has shown that investors may prefer such obligations to straight government securities.

Fear of monetary instability is something that only an extended period of successful monetary management by the central bank could overcome. On the other hand, in the light of Cuba's background of only minor exchange fluctuations, and of an inflation considerably less severe than in some other Latin American countries, fear of monetary instability should not weigh too heavily in the investor's judgment.

The problem presented by the insufficient marketability of government securities should not be too hard for the bank to solve. The bank should at all times be prepared to make a market, if bids and offers are thin, and in moments of stress should operate on a larger scale to prevent abrupt fluctuations. In this regulatory activity it should not, of course, attempt to insulate government securities against fundamental trends, since the monetary effects of excessive purchases might easily become embarrassing.

To overcome the investor's traditional inertia, the bank could collaborate with the Treasury in devising special features

to make government obligations attractive, such as redemption by lot with occasional premiums, flotations below par with a good margin for appreciation, tax exemptions, and many other devices which have been used on occasion. In addition, the central bank could engage in an aggressive selling campaign, enlisting the aid of the banks by means of appropriate commissions. The energetic development of the market need not be delayed until the government urgently requires the money. The central bank could begin to operate in its own obligations and in stabilization fund certificates, broadening the market and paving the way for eventual government financing.

A more realistic anticipation, however, is that the government will want to borrow before a receptive market has been prepared. This finally brings us to the question of government financing by the central bank. Such financing may take various forms, among them operations that ostensibly serve different purposes, such as open market operations, loans on government securities, and intervention to stabilize the bond market. All these operations, however, in a small market influence directly or indirectly the government's ability to raise money. Thus, whenever the government needs money, such operations are likely to be carried out — or omitted — with that consideration in mind. Hence the bank's power to conduct any of them, and the limits that should be imposed upon them, must be viewed with respect to their potential use or perversion for government financing purposes.

Excessive government financing has been, of course, the traditional stumbling block for central banks and their monetary policies. The thoroughly ineffective device employed in the past to protect the bank has been private management plus a strict legal limitation upon loans to the government (not always upon their substitute, open market operations). The frequent result has been that, as soon as the government found itself in financial trouble, it overran one or both of these fences, destroying central bank independence and eliminating the limit upon loans.

In the light of present-day trends, it seems idle to discuss at length the pros and cons of private central bank control. No

government setting up such a bank today is likely to forego control, and if it did, the first conflict would probably make it change its mind. Today, the main safeguard against misuse is the more explicit responsibility that will fall upon the government. Quantitative limitations remain possible and under certain circumstances desirable, but here too experience suggests less reliance on the letter of the law and more upon the government's responsibility before the public. Instead of, or in addition to, an outright prohibition on financing in excess of certain amounts, the government should be required to recognize publicly its responsibility for major borrowings. This would make it progressively more difficult for the government to go beyond small amounts.<sup>21</sup> Naturally, all central bank operations which involve aid to the government should be covered by these provisions.

Such safeguards may seem rather weak, but in practice they could hardly prove weaker than their earlier counterparts, upon whose demise they are a melancholy commentary. The troubles which government financing may bring will be lighter the sooner the central bank succeeds in developing a satisfactory market for government securities among the public.

## 7. ANTICYCLICAL POLICY<sup>22</sup>

So far we have discussed the central bank's three main fields of endeavor — exchange regulation, monetary control, and developmental activities — without reference to the dynamics of the Cuban economy. We shall now proceed to view them in what will probably be their true setting, the frequent and extreme ups and downs of a sugar-export economy. As a matter of tradition we shall refer to these fluctuations as cyclical, without thereby postulating any periodicity.

<sup>21</sup> I am far from suggesting, of course, that all government borrowing from the central bank is bad. It is borrowing in excess of what monetary stability can bear that the law should try to curb. Possibly a cyclical form of limitation upon such borrowing — a tightening of reins during upswings and a loosening during downswings — would go some way toward reconciling good economics and realistic legislation.

<sup>22</sup> My indebtedness to Dr. Prebisch, acknowledged earlier, is particularly heavy in this section.

## A. THE CYCLICAL PATTERN

It is evident that, viewed against the background of the cycle, exchange rate stabilization and monetary control potentially conflict with each other, the conflict being the familiar one of external versus internal stability. Developmental activities stand in the middle. Usually these involve some form of credit expansion, but depending upon their character they may either improve or deteriorate the balance of payments, or may do the latter in the short run and the former in the long run.

The conflict of external versus internal stability has sometimes been exaggerated and its existence certainly has been taken for granted more indiscriminately than was warranted. But for Cuba the conflict is a very real one. This follows inexorably from Cuba's dependence upon foreign trade. Exports, as was pointed out in Chapter XII, are by far the largest independent variable and imports the largest leakage, so that booms and depressions are in effect imported, usually from the United States (see Table 15). A rise in exports, produced by rising foreign demand, lifts Cuban incomes and swells the money supply, thus upsetting internal stability. If Cuba wants to salvage some of this stability, she must raise her exchange rate or resort to monetary and fiscal restraints. Either action would be in conflict with external stability: the former would upset it *ipso facto*, the latter by slowing down the rise in imports and thus widening the gap in the balance of payments.

A similar conflict would occur in a depression. Inevitably almost, the cause of the depression would be a fall in exports. Cuba could try to counteract the resultant deflation by exchange depreciation or internal monetary and fiscal expansion. Both actions, however, would again be in evident conflict with external stability.

For an understanding of the rationale of Cuban anticycle policy, it is important to note how the cyclical pattern described above contrasts with that of a key country. For the latter, domestic investment and saving rather than foreign trade are the variables that make the cycle. An upswing caused by a rise in investment will increase imports and thus produce a passive

balance of payments.<sup>23</sup> Foreign countries will react to this stimulation by buying more, and thus the key country's exports will increase also. However, as long as the investment boom lasts, the rise in imports will tend to lead the rise in exports, and the passive tendency in the balance of payments may be intensified by an outflow of capital for foreign investment.<sup>24</sup>

TABLE 15

NATIONAL INCOME IN THE UNITED STATES AND CUBAN INTERNATIONAL  
RESERVE MOVEMENTS, 1929-1947

| <i>Years</i> | <i>National Income in<br/>United States<br/>(billions of dollars)</i> | <i>Cuban International<br/>Reserve Movements<sup>a</sup><br/>(millions of dollars)</i> |
|--------------|-----------------------------------------------------------------------|----------------------------------------------------------------------------------------|
| 1929.....    | 87.4                                                                  | -5.5                                                                                   |
| 1930.....    | 75.0                                                                  | -36.4                                                                                  |
| 1931.....    | 58.9                                                                  | -18.3                                                                                  |
| 1932.....    | 41.7                                                                  | -9.3                                                                                   |
| 1933.....    | 39.6                                                                  | +0.1                                                                                   |
| 1934.....    | 48.6                                                                  | +1.7                                                                                   |
| 1935.....    | 56.8                                                                  | +7.6                                                                                   |
| 1936.....    | 64.7                                                                  | +27.9                                                                                  |
| 1937.....    | 73.6                                                                  | -4.2                                                                                   |
| 1938.....    | 67.4                                                                  | -12.1                                                                                  |
| 1939.....    | 72.5                                                                  | -15.2                                                                                  |
| 1940.....    | 81.3                                                                  | +12.4                                                                                  |
| 1941.....    | 103.8                                                                 | +39.0                                                                                  |
| 1942.....    | 136.5                                                                 | +85.6                                                                                  |
| 1943.....    | 168.3                                                                 | +104.1                                                                                 |
| 1944.....    | 182.4                                                                 | +201.6                                                                                 |
| 1945.....    | 181.7                                                                 | +102.2                                                                                 |
| 1946.....    | 179.3                                                                 | +98.9                                                                                  |
| 1947.....    | 202.5                                                                 | +75.6                                                                                  |

<sup>a</sup> + reserve increase - reserve decrease

Source: *Survey of Current Business*, July 1948 Reprint, p. 5; Table 18.

This chain of events does not confront the key country with a conflict between internal and external stability, for the meas-

<sup>23</sup> Or reduce the existing active margin of the balance.

<sup>24</sup> This may bring about an increase in exports and may rectify the balance of trade, but not the balance of payments.



ures which it must adopt to bring about either are identical. To stop the investment boom from turning into inflation, it must resort to monetary and fiscal contraction; by so halting the rise in incomes and prices the key country also rectifies its balance of payments. The same applies in a depression. A fall in investment leads to general contraction and hence to lower imports and a stoppage of foreign lending. Thus the balance of payments turns active. The expansionary measures required to restore internal stability are those that are also needed to equilibrate the balance of payments; again there is no conflict.

To summarize the argument: the balance of payments of a country depending upon foreign trade, such as Cuba, typically tends to be active in booms and passive in depressions. Exchange reserves rise during the upswing and decline in the downswing and there thus tends to be a clear conflict between internal and external stability. The balance of payments of a key country, on the other hand, tends to be passive in booms and active in depressions — exchange reserves falling during the former and rising during the latter phase — so that ordinarily there is no such conflict.<sup>25</sup>

It must be emphasized that this describes only the typical cyclical pattern. There are many specific instances where even key countries may have passive balances during depressions and vice versa, owing for instance to successive waves of capital movements among key countries or to special internal conditions. Great Britain from 1929 to 1936 is an example of such nontypical key-country behavior. Also, the pattern would not hold true during the rare periods of approximate stability.

During such periods, in fact, the pattern would be the opposite of what it is during the cycle. A key country, while enjoying internal stability, may eventually find a balance of payments disturbance developing, the correction of which would upset internal equilibrium. There would then arise the

<sup>25</sup> Perhaps one may employ this distinction for defining a key country: an internationally important country whose balance of payments tends to fluctuate contrary to the international cycle, deteriorating in booms, improving in depressions.

familiar conflict. Cuba, contrariwise, at a time when no foreign disturbance was operating on its balance of payments, might suffer some internal contraction or expansion that would upset internal and external stability at the same time. The most typical event of this kind, in Latin American countries, has been a government deficit financed with central bank funds. In that case, the measures required to restore internal stability — cessation of deficit spending and of credit expansion — are also those called for in the interests of external stability, and there would be no conflict. However, while for key countries such nontypical patterns have been not infrequent since the First World War, for countries of Cuba's structure they have been the exception. The typical cyclical pattern has predominated and with it the characteristic conflict of external stability on one side and internal stability and the policies required to maintain such stability on the other.

Anticyclical action on the part of Cuba conflicts also with what in gold-standard parlance was known as the "rules of the game." Nevertheless, it should not ordinarily violate what one may regard as a rational standard of international coöperation. This may be worth pointing out in more detail.

When Cuba attempts to offset the inflationary effects of an export boom through internal contraction, she is thereby interfering with the reëstablishment of external stability, because she is implicitly preventing a rise in imports that would tend to close the gap in her balance of payments. By the same token, she is violating the "rules of the game," for she is fostering an increase in her gold and exchange reserves and is making it harder for the key countries — in practice the United States — to right their balances of payments. But from an international as well as a domestic viewpoint, this is precisely what Cuba should do. In the world-wide boom, she would be foolish to join deliberately in the general debauch merely for the sake of equating her balance of payments. The way to help stop the boom is to go slow and thereby to help the key countries to go slower themselves. If every secondary country does this, the key countries will not find their internal booms aggravated by

foreign repercussions, and can bring them under control more easily.<sup>26</sup> This implies, incidentally, that the usually passive role of secondary countries in the origination of international fluctuations cannot be regarded as an excuse on their part for not doing their share to stop these movements.

In a downswing, the same principles remain true, *mutatis mutandis*: by partly offsetting the contraction produced by shrinking exports, Cuba would be drawing more heavily upon her exchange reserves. She would thus be violating the ancient rules of the game, but she would be aiding her own economy and, by maintaining larger imports, would also be doing her share toward world recovery. In both major phases of the cycle, therefore, Cuba as well as the rest of the world stand to benefit by Cuba's contravention of the "rules."

For key countries, conditions naturally are reversed. During a typical cycle, the action required to curb the boom or mitigate the depression is precisely that called for by the rules of the game. Of course this does not apply to the nontypical situations mentioned before, or to periods of temporary stability.

#### B. COMPENSATORY CENTRAL BANK ACTION

What, under these circumstances, should be the general outlines of the central bank's anticyclical action? The critical phase is during the downswing. At that time the central bank can do the most good, but it also faces the greatest risks. If it overdoes the business of compensating, it will be courting excessive loss of reserves, inflation, and eventual currency depreciation. How far the bank can go, therefore, depends very largely upon the size of the reserves it has been able to accumulate during the boom and how far internal credit expansion has been held in check during that period. The central bank must anticipate that a large part of the additions made to the

<sup>26</sup> The situation described above is that which presented itself to Cuba at the end of the First and the Second World War. It represents the final inflationary stage of a boom and calls for strong fiscal and monetary restraints. A different policy would be in order during the initial phase. In her own self-interest it would be unwise for Cuba to put on the brakes too early, and it would also add to the burdens of the key countries, who in any case must drag the world economy back up the hill.

money supply during the boom will tend to flow out of the country during the downswing. Thus, it is during the upswing that the central bank deals itself the cards which it must play during the depression.

Central bank action during the boom consequently has two aims: the immediate one of checking harmful inflationary excesses and the long-term one of laying the groundwork for a sound antidepression policy. Both call for sterilization of as large a part as possible of the exchange inflow and for limitation of new credit creation. The devices which are available have already been described. The bank will probably have only indifferent success in absorbing the resulting additional money supply in the hands of the public. It may find it easier to curb the expansion of bank credit that would become possible on the basis of the added reserves. At the same time it must endeavor to undo the results of any credit expansion in which it may have engaged during the preceding depression. It must press the banks to liquidate rediscounts, must do whatever is humanly possible to induce the government to repay its borrowings, and must sell out to the public as much as it can of the government securities it may have purchased during the depression.<sup>27</sup> The smaller it can make the proportion of the money supply not backed by foreign exchange, the less the danger that a subsequent contraction will lead to an exhaustion of reserves. To permit a substantial increase in the uncovered part of the money supply, through internal credit creation, is to court depreciation during the next depression.

While conducting a general policy of compensatory contraction, the central bank naturally should engage in new credit operations of its own as sparingly as possible. Preferably it should do so only, if at all, for undertakings that eventually will improve the balance of payments by adding to exports or substituting a domestic product for imports. The bank will probably not be able to refrain altogether from some such operations if it is to do its duty as a developmental as well as a

<sup>27</sup> Early during the upswing a certain liberality regarding government financing may still be in order, to speed recovery and allow the government to complete the public works that may be under way.

regulatory institution. While in principle developmental projects should be pushed during the depression and held back during the boom, this may often prove difficult, because it conflicts with normal business and governmental psychology. Enthusiasm for new ventures flourishes in good times but is hard to stimulate in bad times. Governments, too, are hard to convince that the time to spend is *not* when the money is available — and so is the general public.<sup>28</sup> Thus, the asceticism of pure fiscal and monetary policy may have to be adulterated somewhat to meet the frailties of human nature; and the central bank, while practicing it in some directions, may find it expedient to sin a little in others.<sup>29</sup>

The more the bank succeeds in absorbing liquidity and restraining the boom, the better it will be geared to meet the depression. Once the peak of the international boom is passed, the bank will encounter a sharp reversal in the balance of payments. Exports and new investment from abroad will shrink, while imports will still be maintained at a high level, with the probability of a flight of capital developing. Now the central bank must begin its maneuverings between the Scylla of deflation and the Charybdis of extreme loss of reserves. It must support the banks in order to prevent liquidation of loans, must support the securities markets and help the government to finance public works or even to cover a straight budget deficit, and perhaps must finance the purchase of unsalable export surpluses. If the pressure is anything but brief or mild, the bank will probably find that it cannot continue to support the economy without taking steps to control directly the repercussions of its credit creation upon the balance of payments. Exchange control over capital movements would be the first move in this direction, which the bank might find advisable to make at a

<sup>28</sup> The government may have good political reasons for its unwillingness to postpone expenditures, since by doing so it may merely be leaving a fat treasury or large central bank reserves to the next administration.

<sup>29</sup> Nevertheless, even if some net central bank credit expansion should result from these operations, this would not necessarily mean that the bank was intensifying the already highly unstable character of the Cuban monetary mechanism. It could put the brakes on this mechanism at other points, primarily by raising the member bank reserve requirements, thus curbing the secondary repercussions of the active balance of payments.

fairly early stage. The next and much more serious step would be exchange control over current transactions, or direct import restrictions. This would give the bank a good deal of leeway to continue its compensatory policy. Nevertheless, if the depression is prolonged and severe — a calamity justly but not very specifically described as “fundamental disequilibrium” — exchange depreciation may become necessary.

The rule implicit in the suggested sequence of defensive measures that exchange control over current account transactions should be tried before refuge is sought in depreciation, does not, of course purport to be an invariant one. The choice depends upon the circumstances of the country, the nature of the depression, conditions in world markets, and similar factors. In some countries, exchange control is regarded as undesirable for reasons not of an economic character. In general, nevertheless, exchange control seems to be preferable to depreciation, if one or the other is required for the conservation of exchange resources during a cyclical depression.

The main argument in favor of exchange control is that it is a more inherently transitional measure than depreciation. This is due partly to its administrative flexibility, permitting gradual variations in the intensity of control, and also to the selectivity with which it can be applied, which permits broader repercussions to be kept to a minimum. While it is true that an exchange control that leads to the isolation of the domestic price structure from world markets has a strong tendency toward self-perpetuation, this danger is much smaller in an export economy, where the entire price level is closely geared to international prices, than for countries in whose markets exports and imports play less of a role.

Exchange depreciation, in contrast, is a much more definitive measure, and much less likely to be reversed when conditions become favorable again. This is obvious in view both of the broad and incisive character of the measure and of its wide repercussions throughout the economy. If depreciation were employed as a normal cyclical defense measure, a steady secular downtrend of the value of the currency from one depression to the next would become almost a certainty. Where the exist-

ing rate is one which keeps the balance of payments in approximate equilibrium over the period of a whole cycle, it is plainly preferable to maintain this rate if it can be done without extreme sacrifices.

It is clear, of course, that exchange control does nothing to alleviate the price-cost squeeze which a depression is likely to put upon exporters, nor to increase the receipts of foreign exchange. If the pressure is very intense, or if exchange reserves are low, depreciation may be preferable to exchange control,<sup>30</sup> or both may become necessary at the same time.<sup>31</sup> However, there are usually sufficient uncertainties about the ultimate effects of depreciation, in view of the danger of retaliation from competitors and of the inelastic world demand for most raw materials, that the decision should be approached with great hesitation. For a country like Cuba, accustomed to a stable currency and with its new monetary institutions, so to speak, on trial, depreciation would constitute so grave a step that the bank must at all times consider whether it had not better limit its compensatory action in order to reduce the danger of being forced to depreciate. This brings us to the question, therefore, of what criteria the bank should employ to guide its policy.

### C. CRITERIA OF POLICY

The ordinary central bank reserve ratio — the proportion of the bank's exchange assets to its sight liabilities — is of course the least useful guide. The reasons why in key countries this ratio has been largely abandoned as a guide to policy are familiar. In Cuba, although the need for a clear and simple

<sup>30</sup> A cyclical disequilibrium, in other words, may become so severe that it deserves to be classed as "fundamental," even though it can almost certainly be expected to reverse itself once a world-wide upswing sets in.

<sup>31</sup> There is also the possibility of selective depreciation, through a system of multiple rates. When these multiple rates are determined, not arbitrarily, but through the play of the market forces affecting different categories of exchange as in the Paraguayan exchange control system and to some extent in the system employed in the past by Argentina, there results a combination of exchange control and selective depreciation which is self-liquidating. The premiums upon certain types of exchange vanish as soon as the scarcity which produced them has been overcome.

guide is relatively greater, there are additional considerations which diminish the usefulness of the ordinary reserve ratio for this purpose.

The central banks must hold reserves against the two main types of contingencies: (1) a passive balance on current account and (2) an outflow of capital (so long as capital movements are not permanently controlled). The simple reserve ratio indicates primarily how well the bank is fortified to meet the second contingency, since the volume of central bank sight liabilities may be regarded as an index of the liquidity of the economy and hence of the potentialities for capital flight. It does not indicate very clearly how well the bank is prepared to take care of the country's import needs in case of a drop in exchange receipts from exports. This would be shown better by a ratio relating exchange reserves to the current-account debits in the balance of payments. The new legislation adopted in Paraguay embodies a reserve ratio based upon this latter principle.<sup>32</sup>

But the philosophy of any kind of reserve ratio as a guide to policy leads to peculiarly perverse results in Cuba, because of the character of the Cuban cyclical pattern. It is a philosophy which was originated through the experience of England before 1914, and which from a cyclical angle made excellent sense there. Since the British balance of payments typically tended to be passive toward the peak of a boom,<sup>33</sup> the reserve ratio of the Bank of England would tend to fall at that time. The approach to the danger level indicated that a halt had to be called to further expansion. This the Bank of England had no great

<sup>32</sup> In this legislation, the ratio is that between the net foreign exchange assets of the central bank and the annual average of the central bank's exchange sales for the last three years (comprising virtually all current-account exchange transactions). Since there are provisions for quasi-permanent control of capital movements, there was no need to formulate the reserve ratio with respect to anything but current-account debits; central bank liabilities, as an index of the potentialities of capital flight, could be disregarded. For countries without such controls, a combination of the two kinds of ratios might be preferable. See Triffin, *Monetary and Banking Reform in Paraguay*.

<sup>33</sup> Statements regarding the balance of payments of Britain before 1914 are somewhat hazardous. The movement in the Bank of England's gold reserves is presumptive evidence only, since its relation to the balance of payments is obscured by internal gold movements and other factors.



difficulty in doing. The downward swing of the cycle that followed the final tightening of credit, automatically turned the balance of payments in Britain's favor and replenished the bank's reserves.<sup>34</sup> The eventual restitution of reserves to a satisfactory level would be the signal for a relaxation of the tight policy, which then would help to initiate a recovery.

In the British cycle, therefore, the reserve ratio tended to give signals which were perfectly rational from the cyclical point of view. Many special cases can be pointed to, of course, in England as well as in the United States, where this was not the case because the balance of payments difficulty was not related to any cyclical movement. This in part is the reason why the reserve ratio criterion has become so discredited. Nevertheless, given the *typical* cyclical pattern of a key country, its logic is unimpeachable. This is the corollary of the point made above that in a key country there is no cyclical conflict between internal and external stability and that in such a country the "rules of the game" as postulated by the gold standard are perfectly rational, given the typical cyclical pattern.

In Cuba, however, the policy signals given by the reserve ratio — no matter on what principle it is calculated — are clearly perverse. Exchange reserves rise sharply during the upswing, and so does the reserve ratio. At the precise moment, therefore, when the central bank should bend every effort to hold credit expansion down, it is made to look and feel rich, and by reserve ratio reasoning could afford to expand considerably. If the bank itself should not think so, the treasury and the bankers probably will. During the decline, on the other hand, when a certain amount of compensatory expansion is warranted, the ratio is pulled down by the rapid reduction in reserves, and may frighten the bank into ill-considered contraction. A very low level of reserves, of course, represents a danger signal that the bank cannot afford to ignore. But a sensible compensatory policy which keeps in mind the need to

<sup>34</sup> This refers to the major movements in bank rate and in the cycle. The numerous minor adjustments in which the bank engaged at certain times merely influenced the flow of capital, but not necessarily the cyclical trend.

maintain a certain minimum of reserves is a very different thing from a policy governed at all times by the dread of a falling reserve ratio.

Hence, while the reserve ratio retains some importance as an indicator of the limits beyond which compensatory policy should not go — a warning signal that may come into play in the latter stages of a depression — at most times during the downswing and throughout the upswing the central bank must guide itself by other standards.

We may briefly outline these standards. While a pronounced cyclical upswing is in progress, the bank may adhere to the simple principle of "the less the better." The more vigorously it can restrain credit expansion and absorb part of the liquidity produced by the balance of payments and by its compensatory activities during the preceding depression, the more successful it will be. The bank might observe some arbitrary standard such as that employed by the Bank of Paraguay, which is required to take corrective action if there is an increase in the money supply of over 10 per cent annually that appears to have inflationary implications.<sup>35</sup> However, this must not be interpreted to mean that an annual increase of less than 10 per cent would be innocuous or, even worse, that the bank could expand the money supply at that rate when no cyclical factors are operating. In the absence of a clear cyclical trend, the bank could and should expand, but at a much slower rate — one approximating the annual growth factor of the country. The bank must shun, as it values its exchange stability, a credit policy based upon the misleading evidence of a high or rising reserve ratio.

During the downswing the bank's main guide should be the domestic situation, that is, the need to prevent extreme deflation. It must, however, calculate the effects of its compensatory action upon its exchange reserves, and avoid their complete or too rapid exhaustion. To this end, it may formulate a plan or budget establishing the maximum volume of assistance it can give, under realistic assumptions as to the supplementary defense measures that it is prepared to adopt, such as control over capital movements or over-all exchange control. It should

<sup>35</sup> See Triffin, *Monetary and Banking Reform in Paraguay*.

specify for itself the levels in its reserve position at which, given its appraisal of the state of the cycle, it will move to implement these defense measures. Naturally such planning must be flexible, in view of the many unforeseeable contingencies of the cycle. Nevertheless, the plan will enable the bank to make more effective use of its resources and will protect it better against overrunning the danger points than simple reliance upon the reserve ratio. The penalty for passing the danger points is suffocation by tight exchange control, or premature and undesirable depreciation.

#### D. CONCLUSIONS

It may be well to conclude these observations on anticyclical policy with a note of caution. No amount of elaborate legislation or novel tools can alter basic facts, and in Cuba the facts are weighted heavily against cyclical control. It is true that monetary policy seen in the abstract, could be very powerful, because the Cuban economy remains highly sensitive to monetary factors. The factors which have blunted monetary policy in the United States have not yet developed. But paired with this sensitivity, unfortunately, is the weakness of the *tools* of monetary policy in the Cuban environment, and the consequent difficulty of molding monetary developments in the image of ideal policy. That weakness is the result both of the inadequacy of the money market and of the overwhelmingly powerful disturbances emanating from the balance of payments.

These pessimistic conclusions apply not only to monetary devices as such, but to the entire field of monetary and fiscal action, particularly during depressions. An economy living chiefly by exports does not lend itself well to internal stimulation. To keep things running normally it would be necessary to buy up unsalable export surpluses, with all the grave difficulties of future disposal and market pressure which that entails. Public works and other internal developments find their limits in the lack of mobility of productive factors. Moreover, the high propensity to import rapidly drains away exchange reserves whenever national income is kept high relative to other countries. If the drain is partly plugged by exchange

control, demand concentrates upon the domestic market and, meeting there with inelastic supply conditions, pushes up prices, thus intensifying the disequilibrium. If adjustment is then sought through depreciation, the continuance of internal expansion plus the price effect of depreciation itself will soon re-create the problem. A country of Cuba's structure at best can mitigate, but never even approximately compensate, the effects of imported booms and depressions.

Thus, the success to which the Cuban central bank can aspire in its anticyclical operations is modest. This lends color to the view that the bank's potentialities generally are in danger of being overestimated by an enthusiastic public. The discussions revolving around the various bank projects have been intense and have raised to a high pitch the public's hopes about what the bank could do. If, as one must expect, the bank does not succeed in banishing all poverty from the island within a few years, it is likely to be blamed. On the other hand, this embarrassingly strong interest shown by the public also may have its advantages. Close public observation is an excellent safeguard against all kinds of pressure upon the bank's policies. In this way, the bank may find in the public a strong guardian of its integrity and independence.



## APPENDIX A

### ESTIMATES OF THE VOLUME OF CURRENCY AND COIN, 1912-1947

THE CUBAN TREASURY, beginning in 1926 published annual estimates of the total stock of currency and coin in Cuba, which were based partly on known data, partly on rather uncertain approximations. Only the amount of notes and coin held in its own vaults, and the holdings reported by the banks were accurately known to the Treasury. In addition, the Treasury assumed that until 1930, the entire Cuban gold coinage, amounting to 23.8 million dollars, was still circulating in the island and included it in the statistics. There is every reason to believe, however, that Cuban gold coins had begun to be exported soon after they had been placed in circulation, and had continued to emigrate in spite of the gold export embargo imposed in 1914.<sup>1</sup> Thus, one of the assumptions underlying the Cuban Treasury's early statistics is clearly unwarranted. Of the volume of United States dollar bills and coins outside the Treasury and the banks, the Treasury prior to 1938 could make only vague estimates.

Before 1930 the methods followed by the Treasury in estimating the unknown items frequently were particularly hazardous. Thus at one time the procedure adopted was to multiply by four the amount of dollar bills in the Treasury and the banks, and to accept the result as an estimate of the dollar bill holdings of the public, on the erroneous assumption that a

<sup>1</sup> The exportation of Cuban and United States gold coins was prohibited by Decree 50 of April 21, 1917. The decree stated that this measure had become necessary because Spanish demand for gold had caused United States and even the newly minted Cuban gold coins to be exported, and had created a premium on gold in the Cuban market over United States dollar bills. See "Legislación Monetaria," in Secretaría de Hacienda, *Boletín Oficial*, 1920.

TABLE 16  
MONETARY DATA OF THE CUBAN TREASURY, 1919-1931<sup>a</sup>  
(In millions)

| End of | Dollar<br>Bills <sup>b</sup> | Gold Coins <sup>c</sup> |              | Silver Coins |              | Copper and<br>Nickel Coins <sup>d</sup> |      | Total <sup>e</sup> |
|--------|------------------------------|-------------------------|--------------|--------------|--------------|-----------------------------------------|------|--------------------|
|        |                              | U S                     | Cuba         | U S          | Cuba         | U S                                     | Cuba |                    |
| 1919   | 100.0                        | 45.0                    |              | 6.0          |              |                                         |      | 151.0              |
| 1920   | 150.0                        | 45.0                    |              | 8.5          |              |                                         |      | 203.5              |
| 1921   | 132.7                        | 17.5                    |              | 8.7          |              |                                         |      | 158.9              |
| 1922   | 211.4                        | 37.1                    |              | 16.4         |              |                                         |      | 264.9              |
| 1923   | 331.8                        | 37.1                    |              | 16.4         |              |                                         |      | 385.3              |
| 1924   | 317.4                        | 33.6                    |              | 12.4         |              |                                         |      | 363.4              |
| 1925   | 346.5                        |                         | <sup>f</sup> |              | <sup>f</sup> |                                         |      | <sup>f</sup>       |
| 1926   | 301.5                        | 13.3                    | 23.8         | 3.7          | 8.4          | 1.1                                     | 1.5  | 353.3              |
| 1927   | 144.1                        | 10.6                    | 23.8         | 1.7          | 8.4          | .1                                      | 1.4  | 190.1              |
| 1928   | 108.4                        | 11.8                    | 23.8         | 1.2          | 8.4          | .2                                      | 1.4  | 155.2              |
| 1929   | 66.4                         | 12.3                    | 23.8         | .4           | 8.4          | .1                                      | 1.4  | 112.8              |
| 1930   | 47.8                         | 2.8                     | 23.8         | 1.0          | 8.4          | .2                                      | 1.4  | 85.4               |
| 1931   | 32.5                         | .8                      | 22.2         | .5           | 8.4          | .1                                      | 1.4  | 65.9               |

<sup>a</sup> Comprising currency and coin in circulation, in the Treasury and in banks

<sup>b</sup> Data for 1923-24 include holdings of the Agency of the Federal Reserve Bank of Atlanta. The 1925 figure actually is that reported for June 1926

<sup>c</sup> For 1919-1924, Cuban and United States currency are not reported separately

<sup>d</sup> Data not reported for 1919-1925

<sup>e</sup> Discrepancies are due to rounding

<sup>f</sup> No comparable data available

Sources: Data for 1919-1924 quoted in Bureau of the Mint, *Annual Report of the Director of the Mint*; thereafter, Dirección General de Estadística, *Circulación Monetaria y Movimiento Bancario*.

similar relationship existed in the United States.<sup>2</sup> The amount of United States gold held by the public, according to Irisarri, was likewise estimated by multiplying the quantity in the Treasury and the banks by four.<sup>3</sup> For the period prior to 1930,

<sup>2</sup> Secretaría de Hacienda, *Informe, 1927* (Havana, 1928), p. 117. This notion may have arisen from a somewhat peculiar interpretation of reserve requirements in the United States. An analysis of the Treasury's figures fails to reveal, however, that this procedure was followed consistently. The public's holdings on December 31, 1927, for instance, seem to have been derived by doubling those of the Treasury and the banks.

<sup>3</sup> Irisarri, *La Moneda Cubana*, p. 17. This method also does not seem to have been followed regularly. In 1925, for instance, the public's total gold holdings, both American and Cuban, appear to have been derived by multiplying by four the holdings of the Treasury and the banks. In 1943, the multiplication factor seems to have been three.

therefore, the Treasury's calculations lead to a gross overestimate of the probable volume of currency and coin.

The method employed in Chapters II and IV of estimating the dollar circulation by means of cumulative import and export data for dollar currency, requires a base date for which the circulation can be calculated directly. This base date is the year 1929, for which such a calculation can be carried out by adding up the withdrawals of old, large-size dollar bills effected by the Agency of the Federal Reserve Bank of Atlanta in connection with the issuance of the new smaller currency.

The withdrawals after December 31, 1929 aggregated 80.5 million dollars. To this must be added 13.1 million of new, small-size currency shipped to Cuba before that date, making a total of 93.6 million. Allowance must also be made for a roughly estimated 7.5 million dollars of old notes that may have been carried out by tourists before they could be withdrawn by the agency. The total of 101.1 million, however, must be reduced by 23 million dollars that were held by the agency, since the latter's stock of notes cannot be regarded as part of the Cuban dollar supply. The remainder of 78.1 million represents the total stock of dollars in Cuba at the end of 1929.

It is not impossible that some large-size notes were hoarded and never exchanged, in which case they ought to be added to the 1929 total. About the existence of fairly sizable hoards there can, in fact, be no doubt. In a country where the capital market is undeveloped, bank runs are frequent, and monetary stability is not always assured, hoarding is an inevitable phenomenon.<sup>4</sup> It is not likely, however, that many hoarders should have neglected to exchange their old notes for new, and the amount of old notes that were not withdrawn was, therefore, probably small. No allowance is made for them in the 1929 estimate. Table 17 shows the adjusted series for all types of currency and coin for the years 1912-1947.

<sup>4</sup> According to a contemporary observer, 100 million dollars disappeared into hoards after the collapse of numerous Cuban banks in 1920-21. Although this estimate almost certainly is much exaggerated, it conveys an idea of how intense the propensity to hoard must at times have been. See *Cuba Review*, July 1921, p. 9.



TABLE 17

TOTAL STOCK OF CURRENCY AND COIN IN CUBA, 1912-1947<sup>a</sup>  
(In millions)

| End of<br>Year | Dollar<br>Bills <sup>b</sup> | Gold Coins <sup>c</sup> |                  | Silver Coins |      | Copper and<br>Nickel Coins <sup>d</sup> |      | Silver<br>Certificates | Total              |
|----------------|------------------------------|-------------------------|------------------|--------------|------|-----------------------------------------|------|------------------------|--------------------|
|                |                              | U. S.                   | Cuba             | U. S.        | Cuba | U. S.                                   | Cuba |                        |                    |
| 1912           |                              |                         |                  |              |      |                                         |      |                        | 55-75 <sup>e</sup> |
| 1918           |                              |                         |                  |              |      |                                         |      |                        | 90.0 <sup>e</sup>  |
| 1919           |                              |                         |                  |              |      |                                         |      |                        | 131.0              |
| 1920           | 150.0 <sup>f</sup>           | 26.0                    | 19.0             | 6.0          | 8.4  | 1.3                                     | 1.4  |                        | 212.1              |
| 1921           | 134.7                        | 18.1                    | 19.0             | 3.8          | 8.4  | 1.1                                     | 1.4  |                        | 186.5              |
| 1922           | 135.8                        | 18.1                    | 19.0             | 3.8          | 8.4  | 1.1                                     | 1.4  |                        | 187.6              |
| 1923           | 130.0                        | 18.1                    | 19.0             | 3.8          | 8.4  | 1.1                                     | 1.4  |                        | 181.8              |
| 1924           | 130.6                        | 14.6                    | 19.0             | 3.8          | 8.4  | 1.1                                     | 1.4  |                        | 178.9              |
| 1925           | 114.6                        | 14.0                    | 19.0             | 3.7          | 8.4  | 1.1                                     | 1.4  |                        | 162.2              |
| 1926           | 113.9                        | 13.3                    | 19.0             | 3.7          | 8.4  | 1.1                                     | 1.4  |                        | 160.8              |
| 1927           | 96.1                         | 10.6                    | 19.0             | 1.7          | 8.4  | .1                                      | 1.4  |                        | 137.3              |
| 1928           | 83.2                         | 11.8                    | 19.0             | 1.2          | 8.4  | .2                                      | 1.4  |                        | 125.2              |
| 1929           | 78.1                         | 12.3                    | 19.0             | .4           | 8.4  | .1                                      | 1.4  |                        | 119.7              |
| 1930           | 52.1                         | 2.8                     | 17.5             | 1.0          | 8.4  | .2                                      | 1.4  |                        | 83.4               |
| 1931           | 46.7                         | .8                      | 15.8             | .5           | 8.4  | .1                                      | 1.4  |                        | 73.7               |
| 1932           | 31.3                         | 1.5                     | 9.8 <sup>g</sup> | .3           | 12.0 | .1                                      | 1.4  |                        | 56.4               |
| 1933           | 39.8                         | 1.5                     | 4.8              | .4           | 18.0 | .1                                      | 1.4  |                        | 66.0               |
| 1934           | 37.5                         |                         |                  | .5           | 28.0 | .1                                      | 1.4  |                        | 67.5               |
| 1935           | 30.4                         |                         |                  | .2           | 20.0 | .1                                      | 1.4  | 20.0                   | 72.1               |
| 1936           | 25.5                         |                         |                  | .2           | 14.4 | <sup>h</sup>                            | 1.4  | 40.6                   | 82.1               |
| 1937           | 26.6                         |                         |                  | .2           | 18.0 |                                         | 1.4  | 50.0                   | 96.2               |
| 1938           | 27.8                         |                         |                  | .1           | 16.5 |                                         | 1.5  | 61.8                   | 107.7              |
| 1939           | 27.0                         |                         |                  | .1           | 13.2 |                                         | 1.5  | 76.0                   | 117.8              |
| 1940           | 30.7                         |                         |                  | .1           | 10.6 |                                         | 1.5  | 78.7                   | 121.6              |
| 1941           | 46.0                         |                         |                  | .2           | 9.8  |                                         | 1.5  | 79.5                   | 137.9              |
| 1942           | 106.7                        |                         |                  | .4           | 9.3  |                                         | 1.5  | 105.5                  | 223.4              |
| 1943           | 174.3                        |                         |                  | .9           | 8.2  |                                         | 1.6  | 132.1                  | 317.1              |
| 1944           | 235.2                        |                         |                  | 4.9          | 8.1  |                                         | 2.0  | 234.2                  | 484.4              |
| 1945           | 249.0                        |                         |                  | 5.7          | 8.0  |                                         | 2.0  | 310.8                  | 573.7              |
| 1946           | 284.7                        |                         |                  | 6.3          | 8.0  |                                         | 3.7  | 336.3                  | 639.0              |
| 1947           | 305.5                        |                         |                  | 6.5          | 8.0  |                                         | 4.5  | 443.3                  | 767.8              |

<sup>a</sup> Comprising currency and coin in circulation, in the Treasury, and in banks. Holdings of the Atlanta agency are excluded.

<sup>b</sup> Based on cumulative exports and imports of currency.

<sup>c</sup> For 1920-1925, the data quoted in *Annual Report of the Director of the Mint* have been used, after eliminating certain obvious inconsistencies. The Cuban gold coins are estimated on the assumption that 4.8 million were exported prior to 1920. For 1926 and later, the data are those of the Cuban Treasury.

In the currency export and import statistics reported by the Cuban Treasury, the major item consists of the shipments of the Atlanta agency. While the agency was in operation (1923-1938), only minor shipments were made by the commercial banks. To the extent that these were made by or to New York banks, they were included in the Treasury's statistics. The figures also comprise some further shipments, in which New York banks did not participate. During this period, therefore, the data on bank shipments of currency probably are fairly complete.

The figures fail to account, however, for the currency carried in and out by travelers, a very important item. At present no wholly reliable data on tourist expenditures are available, and information on currency movements through tourists is likewise uncertain. There is some reason to believe — in the light of the Cuban export tax on money or its equivalent, of the familiar preference of Cubans for shopping in Miami, and of the uncertainties of the postwar economic outlook — that in recent years a sizable unreported outflow has taken place. Since no basis exists, however, for estimating its magnitude, no adjustment in the currency figures has been made.

A correction was made, however, for an unrecorded outflow believed to have taken place in 1934 as a result of the temporary establishment of an ineffective exchange control. Although comprehensive data on this illegal movement naturally do not exist, it was said that a few individuals alone were known to have taken out over 100,000 dollars each. The newspapers reported that smuggling of currency was widespread. A very rough but not unreasonable guess might put the illegal outflow at approximately five million dollars. This amount has been added to the 1934 currency exports.

This adjustment brings the cumulative dollar series into line with an independent estimate made by the Cuban Treasury for

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<sup>d</sup> For 1920-1925, the data quoted in *Annual Report of the Director of the Mint* have been used. The segregation of Cuban and United States coins has been made on the basis of known amounts of the Cuban coinage. For 1926 and later, the data are those of the Cuban Treasury.

<sup>e</sup> Contemporary estimates.

<sup>f</sup> Based on estimates quoted in *Annual Report of the Director of the Mint*, 1921.

<sup>g</sup> For 1932-33, estimates of *Cuba Económica y Financiera* are used, as quoted in Pérez and Pazos, *El Problema Monetario*, p. 160. From 1934 on, the small remaining stock of gold coins has not been included in the aggregate stock of money, since the coins had been demonetized.

<sup>h</sup> United States copper and nickel coin reported under silver.

the year 1938. For some years prior to December 1938, the Treasury had employed as a basis for its published data the periodic estimates supplied by the Atlanta agency. When this source of information dried up with the closing of the agency in the latter part of that year, the Treasury approached the local bankers for an estimate of the dollar circulation. The consensus among the bankers was that the dollar circulation outside the banks equalled approximately 80 per cent of the banks' own holdings.<sup>5</sup> On this basis, the Treasury estimated the aggregate stock of dollar bills, inclusive of bank holdings, at \$27,954,588, plus \$147,378 in United States gold and subsidiary coin. The cumulative series, after the adjustment for an unrecorded outflow in 1934, agrees sufficiently well with the Treasury figure to permit a merging of the two series from 1938 onwards.<sup>6</sup>

For the years preceding the inception of the Treasury's data on currency shipments, which began in 1924, only isolated figures from scattered sources are available, and these probably give insufficient coverage. Currency movements during 1920 and 1921 in particular were exceptionally hectic. The former year witnessed a great inflow of currency into Cuba, induced first by the immense prosperity enjoyed by the island during the early part of the year, and thereafter by the shortage of circulating medium resulting from the bank moratorium declared in October. Liquidation followed in 1921 and caused large amounts of currency to be exported. No attempt therefore has been made to carry the cumulative currency estimates beyond the end of 1921. Even for that year the estimate must be regarded as extremely uncertain. It is made somewhat more plausible by the fact that it happens to agree fairly well with the Cuban Treasury's own contemporary estimate for that

<sup>5</sup> Dirección General de Estadística, *Circulación Monetaria y Movimiento Bancario*, 1936-1941, p. 1.

<sup>6</sup> A sharp discrepancy exists between the June 30, 1938, figure of 56.3 million, the last of those furnished by the Atlanta agency, and the Treasury's own estimate of 27.9 million for the succeeding December. Since net exports during the second half of 1938 were only 6.8 million, a continuation of the Atlanta series would have yielded 49.5 million. The figures furnished by the agency appear to contain a cumulative error, but it has not been possible to ascertain its nature.

year, but this does not constitute a very strong endorsement, in view of the Treasury's erratic methods of arriving at its estimates.

Prior to 1921, any estimate of the money supply or even of the stock of currency and coin must remain purely conjectural. A few isolated data exist, but no illusions can be entertained about their accuracy. Since even such scattered items, however, as can be pieced together throw an interesting light upon the rate of expansion of the Cuban currency, their detailed discussion is not without value.

For the year 1912, an estimate exists that places the total Cuban stock of French, Spanish, and United States gold and silver coins at 33 million pesos.<sup>7</sup> However, a study of gold and silver exports from Cuba during the years 1914-1917, employing a technique similar to that used for estimating the volume of dollar bills in 1929, indicates that this figure is too low. It may be assumed that between 1914 and 1917 practically all of the Spanish and French coins that had not been shipped to the United States for reminting were exported to Spain, since these coins could no longer circulate in Cuba, while the Spanish demand for gold was so intense that even United States and Cuban gold was sent from Cuba to Spain.<sup>8</sup> Total Cuban exports of gold and silver from 1914 to 1917 amounted to 64.8 million pesos, of which 20.9 million went to the United States and 43.6 million to Spain.<sup>9</sup>

It is therefore obvious that if no coins had been imported into Cuba during the period in question, the amount in existence before 1914 must have been at least equal to the 64.8 million pesos subsequently exported. During these years, however, Cuba did import a total of 64.0 million pesos of gold and silver, of which some 31.0 million are accounted for by the new

<sup>7</sup> Bureau of the Mint, *Annual Report of the Director of the Mint*, 1913, p. 33.

<sup>8</sup> See p. 35.

<sup>9</sup> Cuban export statistics for 1917 do not refer to gold and silver, but to "money" in general. These exports of "money" to the United States exceeded United States imports of gold and silver from Cuba, as shown by United States customs statistics, by roughly 2 million. The difference probably was accounted for by dollar bills and has therefore been deducted in order to arrive at Cuban gold and silver exports.

Cuban coins arriving from the Philadelphia Mint and the rest by United States coins. It is also known that some of the gold shipped to Spain was of United States and Cuban coinage. It is hard to believe, however, that Cuba should have imported and exported, in a period of four years, an amount of coin equal to more than twice her total stock before 1914. These considerations point to the conclusion that while the 1912 stock of coin probably was less than the 64.8 million exported, it must have been higher than 33 million. An amount of 40 to 50 million may be a justifiable guess. To this a certain volume of dollar bills must be added, for which there is no estimate.

An estimate of 350 million dollars for 1914, although quoted by an experienced writer on Cuban economic affairs, must be regarded as wholly out of line.<sup>10</sup> There can be no doubt, however, that during the following years a steady expansion in the stock of currency and coin took place, although no data exist for the increment in any of the years up to 1918. The increment must have come about virtually exclusively through the growth in the volume of dollar bills, since coins were imported and exported in almost equal amounts. The Cuban customs statistics give some information on imports of dollar bills, but the amounts shown are so small compared with the movements which actually must have taken place that no help at all can be expected from this source. García states that the increase in the Cuban money supply was not commensurate with the favorable trade balance of the years 1914-1920, but does not cite data to support this contention.<sup>11</sup>

For the year 1918 an estimate was made by an official of the Banco Nacional, who placed the aggregate stock of currency and coin at about 90 million.<sup>12</sup> This observer assumed that all Cuban gold coins were still in circulation and that the volume of United States money was about twice that of the Cuban. As we know, however, the first of these assumptions is not entirely accurate, and the second fails to make clear

<sup>10</sup> Miguel González Rodríguez, in *Cuba Importadora e Industrial*, July 1932, p. 9.

<sup>11</sup> Comisión Temporal, *Compendio de los Trabajos Realizados*, 1928, p. 25.

<sup>12</sup> William H. Morales, "Money and Banking in Cuba," *Cuba Review* (Havana), December 1918, p. 21.

whether all types of United States money, or dollar bills only, are meant. If the latter interpretation is correct, the estimate of the total would have to be raised by perhaps 10 to 15 million. We shall probably do well to regard the 90 million figure as the lower limit of a range of plausible estimates.

Beginning in 1920, the estimates of the Cuban Treasury become available.<sup>13</sup> The methods employed by the Treasury in making these estimates were commented on above. Although even fewer components of the total circulation were accurately known to the Treasury in 1920 than in subsequent periods, since for these years the cash holdings of banks do not seem to have been reported, the 1920 estimate probably is more nearly accurate than later ones.

<sup>13</sup> Bureau of the Mint, *Annual Report of the Director of the Mint*, 1920-21.

## APPENDIX B

### THE BALANCE OF PAYMENTS

TO SUPPLEMENT THE DISCUSSION of balance of payments adjustments in Chapter XII, I have attempted to compute the Cuban balance of payments for the years 1919-1945. The results are shown in Table 18. While admittedly rough, they may be of some value in illustrating the nature of the balance of payments problem. They should also be referred to in connection with the discussion of exchange control in Chapter XIV. For the years 1946 and 1947 official estimates of the balance of payments by the Dirección General de Estadística have become available. These data, as revised by the technicians of the International Monetary Fund and regrouped so as to adapt them to the series presented for the earlier years, are shown in Table 19, together with a short discussion of a few doubtful items.

#### I. EARLIER STUDIES OF THE CUBAN BALANCE OF PAYMENTS

Before 1946 there appear to have been only three rather cursory attempts to construct an over-all balance of payments for Cuba, and these cover only very limited periods. The most elaborate is the computation made by Moisés Porset Dumás for 1937, which is based upon separate estimates of a number of individual items.<sup>1</sup> Some of these are not particularly plausible, and they do not cover all classes of transactions. The deficit of 17.8 million pesos, which differs considerably from the surplus of 38.4 million pesos shown in the balance of payments as given in Table 18, is not convincing. This judgment is con-

<sup>1</sup> Moisés Porset Dumás, "El Dinero que se nos Escapa," *Carteles*, April 2, 1939.

firmed by Pérez and Pazos, who speak of Porset Dumás' result as "purely conjectural."<sup>2</sup>

The two remaining computations, one by Angel Garri, the other by an agency of the Cuban government, dispense with calculations of individual items and employ as a basis the reported operations of banks with foreign centers.<sup>3</sup> Although these reports probably comprise the great majority of Cuba's international monetary transactions, they are not complete. The reason is that some of Cuba's financial operations are handled directly with banks in the United States or elsewhere, without the intervention of Cuban banks, while many others go through intercompany accounts. If further proof were needed of the incompleteness of these figures, it is provided by the impossibly large passive balances that they appear to indicate. During the years 1931 to 1935 the banks' receipts from abroad were 228.5 million dollars less than their payments, which would imply an equivalent outflow of dollar currency and gold.<sup>4</sup> Hence, the adverse balance that Garri derives on the basis of these figures is obviously erroneous.<sup>5</sup>

The same must unfortunately be said of the balance of payments presented by the Cuban government for the benefit of its bondholders and of the Securities and Exchange Commission in the registration statement for the 4½ per cent bonds issued in 1937.<sup>6</sup> The admittedly much too unfavorable picture given by the banks' reported operations with foreign centers was here embellished by the addition of the total volume of

<sup>2</sup> Pérez and Pazos, *El Problema Monetario*, p. 56.

<sup>3</sup> These operations, which comprise purchases and sales of telegraphic transfers, bills, drafts, checks, letters of credit, and also postal money orders, are published fully, by countries, for the period following the year 1930. Partial reports are available since 1927. See Dirección General de Estadística, *Circulación Monetaria y Movimiento Bancario*, 1926-1935, 1936-1941.

<sup>4</sup> The deficit might have been covered by a reduction in the banks' balances abroad, instead of by a flow of currency, but Table 13 shows that between December 1930 and December 1935 the banks' foreign balances *increased* by 23.5 million dollars.

<sup>5</sup> Angel Garri, "Desfavorable la Balanza de Pagos — Como se Depaupera la Economía Nacional de Año en Año," *Carteles*, May 21, 1939, p. 58.

<sup>6</sup> Registration Statement of the Four and One-Half Per Cent Bonds of the External Debt of the Republic of Cuba, 1937-1977 (1938), p. 15.



merchandise exports and imports. Since the Cuban trade balance is normally active, this "correction" greatly improves the appearance of the total balance; but since the monetary transfers arising from merchandise trade are in large part contained in the bank figures, it is a plain case of double counting. It is purely accidental that the net balances thus computed, ranging from a debit of 8.6 million in 1932 to a credit of 16.3 million in 1936, are of roughly the same order of magnitude as the balances presented in this study. For practical purposes they are without significance.

Much more satisfactory data are available on the bilateral balance of payments between the United States and Cuba. The United States Tariff Commission has published a bilateral balance for the period 1929-1940, which contains everything except the return on direct investments and movements of capital.<sup>7</sup> Further studies have been made by the United States Bureau of Foreign and Domestic Commerce, and by the staff of the Special Adviser to the President on Foreign Trade.<sup>8</sup> These investigations have supplied fairly complete data on most of the items in the Cuban-American balance of payments since 1919. Even here, however, a considerable degree of uncertainty still prevails. To some extent this may be charged to the fact that the analysis of bilateral balances is still in the developmental stage. The unusual complexity of our financial relations with Cuba, interwoven as they are with holding-company problems, is further responsible. The analysts of the Bureau of Foreign and Domestic Commerce have repeatedly found it necessary to revise their estimates for the last few years, which throws some doubt upon uncorrected estimates for earlier periods. In such cases I have made corrections to bring the earlier data more into line with the most recent figures. Even the bilateral balance figures can therefore be accepted only as tentative, and in certain cases as distinctly rough.

The step of expanding the Cuban bilateral balance with the

<sup>7</sup> Tariff Commission, *The Foreign Trade of Latin America*, Part II, p. 266.

<sup>8</sup> Most of the computations for the period before 1929 were made by Dr. August Maffry, then in the Office of the Special Adviser to the President on Foreign Trade.

United States into one with the world was a less critical one than might appear at first sight, because of the overwhelming importance of the American segment. It was facilitated also by the availability of fairly complete data on foreign investments (other than American) in Cuba. Moreover, it seemed legitimate in the case of countries other than the United States, to make limited use of the previously mentioned statistics of the banks' operations with foreign centers, since with such countries the volume of transactions outside the banks is likely to be small. For the period before 1929, however, very rough estimates have had to be resorted to. The accuracy of the annual balances is therefore in inverse proportion to their distance from the present. Those for the early twenties are merely informed guesses.

## 2. COMMENTS ON INDIVIDUAL ITEMS

The preceding general remarks on the Cuban balance of payments may be supplemented with a few comments on individual items in the balance, as presented in Table 18. Attention is called to the technical derivation of the data as well as to their economic significance.

### A. MERCHANDISE TRADE

These data, published by the Cuban Treasury,<sup>9</sup> are probably the most reliable in the entire balance. With the exception of a certain amount of smuggling, and some rum-running during the prohibition period, and of the usual inaccuracies in distinguishing between f.o.b., c.i.f., and other prices, they may be regarded as accurate. This is confirmed by the relatively close agreement of Cuban-American trade statistics as reported by Cuba and as reported by the United States. It will be noted that only one passive *trade* balance was recorded during the entire period, after the crash of 1920-21. A suggestive feature of Cuba's trade with the United States, for which data are not shown, is the sharp decline in the proportion of Cuban *imports* from the

<sup>9</sup> Dirección General de Estadística, *Comercio Exterior*, 1940 (Havana, 1941); *ibid.*, 1940-1945, as reported in *Cuba Económica y Financiera, Anuario Azucarero* (Havana), 1946, pp. 99, 101.

TABLE 18  
THE CUBAN BALANCE OF PAYMENTS  
(In millions of pesos)

|      | TRADE ITEMS         |       |       | SERVICE ITEMS |      |                     |       |      |                      |       |  |
|------|---------------------|-------|-------|---------------|------|---------------------|-------|------|----------------------|-------|--|
|      | Merchandise trade * |       |       | Shipping      |      | Travel expenditures |       |      | Persons' remittances |       |  |
|      | Recd                | Paid  | Bal.  | Btl           | Recd | Paid                | Bal.  | Recd | Paid                 | Bal.  |  |
| 1919 | 574.6               | 356.6 | 218.0 | -26.9         | 10.0 | 10.0                | 0.0   | 1.4  | 18.5                 | -17.1 |  |
| 1920 | 794.0               | 557.0 | 237.0 | -38.3         | 12.0 | 12.0                | 0.0   | 1.4  | 25.0                 | -27.6 |  |
| 1921 | 279.8               | 354.4 | -74.6 | -32.3         | 10.0 | 5.0                 | +5.0  | 1.4  | 18.5                 | -17.1 |  |
| 1922 | 327.7               | 180.3 | 147.4 | -15.8         | 10.0 | 8.0                 | +2.0  | 1.4  | 18.5                 | -17.1 |  |
| 1923 | 422.6               | 268.9 | 153.7 | -20.8         | 11.0 | 10.0                | +1.0  | 1.4  | 18.5                 | -17.1 |  |
| 1924 | 434.9               | 289.9 | 145.0 | -20.1         | 11.5 | 10.0                | +1.5  | 1.4  | 18.5                 | -17.1 |  |
| 1925 | 354.0               | 297.3 | 56.7  | -20.8         | 12.5 | 10.0                | +2.5  | 1.5  | 18.5                 | -17.0 |  |
| 1926 | 301.7               | 260.8 | 40.9  | -21.2         | 12.5 | 9.5                 | +3.0  | 1.5  | 18.5                 | -17.0 |  |
| 1927 | 324.4               | 257.4 | 67.0  | -25.9         | 13.0 | 8.5                 | +4.5  | 1.5  | 18.5                 | -17.0 |  |
| 1928 | 278.1               | 212.8 | 65.3  | -23.7         | 14.0 | 7.0                 | +7.0  | 1.5  | 18.5                 | -17.0 |  |
| 1929 | 272.4               | 216.2 | 56.2  | -13.1         | 14.4 | 7.6                 | +6.8  | 1.5  | 18.5                 | -17.0 |  |
| 1930 | 167.4               | 162.5 | 4.9   | -8.2          | 15.5 | 6.6                 | +8.9  | 1.2  | 16.5                 | -15.3 |  |
| 1931 | 118.9               | 80.1  | 38.8  | -7.6          | 13.6 | 4.6                 | +9.0  | 1.7  | 15.0                 | -14.3 |  |
| 1932 | 80.7                | 51.0  | 29.7  | -3.8          | 8.9  | 2.8                 | +6.1  | 1.5  | 13.4                 | -12.0 |  |
| 1933 | 84.4                | 42.4  | 42.0  | -2.1          | 5.4  | 3.3                 | +2.1  | 1.6  | 9.4                  | -8.8  |  |
| 1934 | 107.7               | 73.4  | 34.3  | -3.0          | 3.7  | 4.0                 | -3    | 1.7  | 6.0                  | -5.3  |  |
| 1935 | 128.0               | 95.5  | 32.5  | -3.9          | 4.4  | 3.9                 | +5    | 1.7  | 6.5                  | -5.8  |  |
| 1936 | 154.8               | 103.2 | 51.6  | -4.1          | 10.7 | 5.5                 | +5.2  | 1.7  | 5.5                  | -4.8  |  |
| 1937 | 186.1               | 129.6 | 56.5  | -3.3          | 11.2 | 5.8                 | +5.4  | 1.8  | 3.5                  | -2.7  |  |
| 1938 | 142.7               | 106.0 | 36.7  | -5.7          | 11.4 | 5.8                 | +5.6  | 1.7  | 3.5                  | -2.8  |  |
| 1939 | 147.7               | 105.9 | 41.8  | -5.2          | 10.1 | 5.1                 | +5.0  | 1.7  | 3.5                  | -2.8  |  |
| 1940 | 127.3               | 103.9 | 23.4  | -5.6          | 13.6 | 2.7                 | +10.9 | 2.5  | 8.9                  | -6.4  |  |
| 1941 | 211.5               | 133.9 | 77.6  | -10.4         | 14.6 | 3.3                 | +11.3 | 3.2  | 5.0                  | -1.8  |  |
| 1942 | 182.4               | 146.7 | 35.7  | -20.5         | 2.8  | .8                  | +2.0  | 3.3  | 8.8                  | -5.5  |  |
| 1943 | 350.6               | 177.4 | 173.2 | -17.0         | .7   | .1                  | +1.6  | 3.3  | 9.2                  | -6.0  |  |
| 1944 | 427.1               | 208.6 | 218.5 | -31.1         | .6   | .6                  | 0.0   | 3.5  | 8.8                  | -5.3  |  |
| 1945 | 409.9               | 238.9 | 171.0 | -33.6         | 2.2  | .6                  | +1.6  | 2.2  | 16.2                 | -14.0 |  |

TABLE 18 (Continued)

| SERVICE ITEMS (CONTINUED)   |      |      |    |                          |      |      |                          |      |      |                         |      |      |                   |        |  |
|-----------------------------|------|------|----|--------------------------|------|------|--------------------------|------|------|-------------------------|------|------|-------------------|--------|--|
| Institutional contributions |      |      |    | Ret on portf. investment |      |      | Ret on direct investment |      |      | Government transactions |      |      | All service items |        |  |
| Recd                        | Paid | Bal. |    | Recd                     | Paid | Bal. |                          | Recd | Paid | Bal.                    |      | Recd | Paid              | Bal.   |  |
| 1919                        | .5   | .1   | +4 | 2.0                      | 2.0  | 0    |                          | 1.0  | 40.1 | -39.1                   |      | 14.9 | 97.6              | -82.7  |  |
| 1920                        | .5   | .1   | +4 | 3.0                      | 2.0  | +1.0 |                          | 1.5  | 44.4 | -42.9                   |      | 18.4 | 121.8             | -103.4 |  |
| 1921                        | .5   | .1   | +4 | 2.0                      | 2.0  | 0    |                          | .8   | 26.2 | -25.4                   |      | 14.7 | 84.1              | -69.4  |  |
| 1922                        | .5   | .1   | +4 | 2.0                      | 2.0  | 0    |                          | .8   | 35.1 | -34.3                   |      | 14.7 | 79.5              | -64.8  |  |
| 1923                        | .5   | .1   | +4 | 3.0                      | 3.0  | 0    |                          | .8   | 40.3 | -39.5                   |      | 16.7 | 92.7              | -76.0  |  |
| 1924                        | .5   | .1   | +4 | 3.0                      | 5.0  | -2.0 |                          | .8   | 46.3 | -45.5                   |      | 17.2 | 100.0             | -82.8  |  |
| 1925                        | .5   | .1   | +4 | 3.0                      | 5.0  | -2.0 |                          | .8   | 52.3 | -51.5                   |      | 18.3 | 106.7             | -88.4  |  |
| 1926                        | .5   | .1   | +4 | 3.0                      | 5.0  | -2.0 |                          | .8   | 59.3 | -58.5                   |      | 18.3 | 113.6             | -95.3  |  |
| 1927                        | .5   | .1   | +4 | 3.0                      | 6.0  | -3.0 |                          | .8   | 52.6 | -51.8                   |      | 18.8 | 111.6             | -92.8  |  |
| 1928                        | .5   | .1   | +4 | 3.0                      | 6.0  | -3.0 |                          | .8   | 43.3 | -42.5                   |      | 19.8 | 98.6              | -78.8  |  |
| 1929                        | .5   | .1   | +4 | 3.0                      | 6.2  | -3.2 |                          | .8   | 38.1 | -37.3                   |      | 20.2 | 83.6              | -63.4  |  |
| 1930                        | .4   | .1   | +3 | 2.0                      | 6.2  | -4.2 |                          | .5   | 27.1 | -26.6                   |      | 19.6 | 64.7              | -45.1  |  |
| 1931                        | .4   | .1   | +3 | 1.0                      | 6.7  | -5.7 |                          | .4   | 21.4 | -21.0                   |      | 16.1 | 55.4              | -39.3  |  |
| 1932                        | .3   | .0   | +3 | .5                       | 5.7  | -5.2 |                          | .1   | 15.0 | -14.0                   |      | 10.3 | 40.7              | -30.4  |  |
| 1933                        | .3   | .0   | +3 | .5                       | 5.4  | -4.9 |                          | .2   | 12.4 | -12.2                   |      | 7.0  | 32.6              | -25.6  |  |
| 1934                        | .3   | .0   | +3 | 1.0                      | 2.4  | -1.4 |                          | .2   | 6.1  | -5.9                    |      | 5.9  | 21.5              | -15.6  |  |
| 1935                        | .4   | .1   | +3 | 1.0                      | 2.3  | -1.3 |                          | .2   | 6.7  | -6.5                    |      | 6.7  | 23.4              | -16.7  |  |
| 1936                        | .5   | .1   | +4 | 1.0                      | 2.2  | -1.2 |                          | .3   | 12.1 | -11.8                   |      | 13.2 | 29.5              | -16.3  |  |
| 1937                        | .5   | .1   | +4 | 1.0                      | 1.9  | -0.9 |                          | .3   | 18.9 | -18.6                   |      | 13.8 | 33.5              | -19.7  |  |
| 1938                        | .4   | .1   | +3 | 1.0                      | 2.7  | -1.7 |                          | .2   | 19.5 | -19.3                   | 8    | 14.5 | 37.3              | -22.8  |  |
| 1939                        | .5   | .1   | +4 | 1.0                      | 2.6  | -1.6 |                          | .2   | 19.6 | -19.4                   | 1.0  | 13.5 | 36.1              | -22.6  |  |
| 1940                        | .6   | .1   | +5 | 1.0                      | 2.4  | -1.4 |                          | .2   | 18.2 | -18.0                   | .2   | 18.1 | 37.9              | -19.8  |  |
| 1941                        | .5   | .1   | +4 | 1.0                      | 2.3  | -1.3 |                          | .3   | 30.1 | -29.8                   | .6   | 20.2 | 51.2              | -31.0  |  |
| 1942                        | .6   | .0   | +6 | 1.1                      | 2.2  | -1.1 |                          | .3   | 29.2 | -28.0                   | 4.1  | 12.2 | 61.2              | -49.3  |  |
| 1943                        | .6   | .0   | +6 | 1.1                      | 2.1  | -1.0 |                          | .3   | 21.2 | -20.8                   | 9.2  | 15.2 | 64.8              | -49.6  |  |
| 1944                        | .5   | .0   | +5 | 1.2                      | 2.1  | -0.9 |                          | .3   | 26.5 | -26.2                   | 13.8 | 19.9 | 69.1              | -49.2  |  |
| 1945                        | .4   | .1   | +3 | 1.3                      | 2.2  | -0.9 |                          | .4   | 20.2 | -19.8                   | 15.5 | 22.0 | 72.9              | -50.9  |  |

TABLE 18 (Continued)

| TOTAL CURRENT ACCOUNT |       |        |       | AUTONOMOUS CAPITAL ITEMS |       |       |       | INTERNATIONAL RESERVE MOVEMENTS |       |                                      |        | RESIDUAL                |                                      |
|-----------------------|-------|--------|-------|--------------------------|-------|-------|-------|---------------------------------|-------|--------------------------------------|--------|-------------------------|--------------------------------------|
|                       |       |        |       | New investment           |       |       |       | Sinking funds, etc              |       | Dollar notes and subsidiary currency |        | Banks' foreign balances | Total reserve movements <sup>b</sup> |
| Recd                  | Paid  | Bal    |       | Recd                     | Paid  | Bal   |       | Bal                             | Bal   | Bal                                  | Bal    | Bal                     | Bal                                  |
| 1919                  | 589.5 | +135.3 | +14.0 | 0                        | 0     | 14.0  | -12.2 |                                 |       | +27.6                                | +27.6  | +164.7                  |                                      |
| 1920                  | 812.4 | +133.6 | +30.0 | 0                        | 0     | 30.0  | -3.2  |                                 |       | +12.6                                | +12.6  | +173.0                  |                                      |
| 1921                  | 204.5 | -144.0 | +14.0 | 0                        | 0     | 14.0  | -3.2  | +7.0                            | +63.9 |                                      | +71.8  | -61.4                   |                                      |
| 1922                  | 342.4 | +82.6  | +63.0 | 0                        | 0     | 63.0  | -4.2  | 0                               | -2.0  |                                      | -2.0   | +139.4                  |                                      |
| 1923                  | 439.3 | +77.7  | +94.0 | 0                        | 0     | 94.0  | -11.2 | 0                               | +5.8  |                                      | +5.8   | +166.3                  |                                      |
| 1924                  | 452.1 | +62.2  | +28.0 | 0                        | 0     | 28.0  | -3.2  | +3.5                            | -6    |                                      | +2.9   | +89.9                   |                                      |
| 1925                  | 372.3 | -31.7  | +17.0 | 0                        | 0     | 17.0  | -3.2  | +6                              | +16.1 |                                      | +16.7  | -1.2                    |                                      |
| 1926                  | 320.0 | -54.4  | +58.0 | 0                        | 0     | 58.0  | -3.2  | +7                              | +7    |                                      | +1.8   | +1.8                    |                                      |
| 1927                  | 343.2 | -25.8  | +42.0 | 0                        | 0     | 42.0  | -4.2  | +2.7                            | +20.8 |                                      | +23.5  | +35.5                   |                                      |
| 1928                  | 297.9 | -13.5  | +16.0 | 0                        | 0     | 16.0  | -4.2  | -1.2                            | +13.3 |                                      | +12.1  | +10.4                   |                                      |
| 1929                  | 292.6 | -7.2   | +18.0 | 0                        | 0     | 18.0  | -5.2  | -5                              | +6.0  |                                      | +5.5   | +11.1                   |                                      |
| 1930                  | 197.0 | -40.2  | +32.0 | 0                        | 0     | 32.0  | -7.2  | +11.0                           | +25.4 |                                      | +36.4  | +21.0                   |                                      |
| 1931                  | 135.0 | -5     | 0     | 0                        | 0     | 0     | -11.0 | +3.7                            | +6.0  | +8.6                                 | +18.3  | +6.8                    |                                      |
| 1932                  | 91.0  | -7     | 0     | 0                        | 0     | 0     | -15.0 | +5.3                            | +15.6 | -11.6                                | +9.3   | -6.4                    |                                      |
| 1933                  | 91.4  | +16.4  | 0     | 0                        | 0     | 0     | -6.0  | +3.0                            | -8.4  | +3.3                                 | -1     | +10.3                   |                                      |
| 1934                  | 113.6 | +18.7  | 0     | 0                        | 0     | 0     | -1.0  | +3.5                            | +2.2  | -7.4                                 | -1.7   | +16.0                   |                                      |
| 1935                  | 134.7 | +15.8  | 0     | 0                        | 0     | 0     | -2.0  | +1.3                            | +7.4  | -16.3                                | -7.6   | +6.2                    |                                      |
| 1936                  | 168.0 | +35.3  | 0     | 0                        | 0     | 0     | -2.3  | +2                              | +5.0  | -33.1                                | -27.9  | +5.1                    |                                      |
| 1937                  | 199.9 | +36.8  | 0     | 0                        | 0     | 0     | -2.6  | 0                               | -1.1  | +5.3                                 | +4.2   | +38.4                   |                                      |
| 1938                  | 157.2 | +143.3 | 0     | 0                        | 0     | 0     | -2.0  | 0                               | -1.1  | +13.2                                | +12.1  | +24.0                   |                                      |
| 1939                  | 161.2 | +142.0 | 0     | 0                        | 0     | 0     | -1.2  | +1.3                            | +8    | +13.1                                | +15.2  | +33.2                   |                                      |
| 1940                  | 145.4 | +141.8 | 0     | 5.2                      | -5.2  | -5.2  | -7    | 0                               | -3.7  | -8.7                                 | -12.4  | -14.7                   |                                      |
| 1941                  | 231.7 | +185.1 | .2    | 12.2                     | -12.0 | -12.0 | -6    | 0                               | -16.3 | -22.7                                | -39.0  | -5.0                    |                                      |
| 1942                  | 194.6 | +208.2 | 19.5  | 2.4                      | +17.1 | -1.3  | -15.0 | -15.0                           | -74.8 | +4.2                                 | -83.4  | +23.9                   |                                      |
| 1943                  | 395.8 | +242.2 | 27.1  | 21.2                     | +59.1 | -1.5  | -30.0 | -30.0                           | -63.1 | -11.0                                | -104.1 | +23.9                   |                                      |
| 1944                  | 447.0 | +277.7 | 5.3   | 19.2                     | -13.9 | -1.5  | -65.0 | -65.0                           | -99.9 | -36.7                                | -201.6 | -47.7                   |                                      |
| 1945                  | 431.9 | +120.1 | 1.3   | 4.7                      | -3.4  | -1.3  | -79.9 | -79.9                           | -14.6 | -7.7                                 | -102.2 | +13.2                   |                                      |

<sup>a</sup> Recd dollars/pesos received by Cuba    Paid dollars/pesos paid by Cuba    balance

<sup>b</sup> + loans of reserves — gain in reserves

United States, following each of the successive increases in the United States tariff in 1921 and 1930. For a detailed analysis of Cuban trade with the United States, the reader may consult the section on Cuba in the United States Tariff Commission's study on *The Foreign Trade of Latin America*.<sup>10</sup> A discussion of the influence that the Reciprocity Treaty has had upon Cuban commercial relations with the United States may be found in Wright, *The Cuban Situation and our Treaty Relations*.

#### B. RETURN ON DIRECT INVESTMENTS

Contrary to popular belief, American investments in the Cuban sugar industry constitute only a minor portion of total United States direct investments on the island. Although during the 1920's sugar investments bulked large, they were subjected to severe shrinkage as a result of almost universal reorganizations; in 1936 they amounted to only 36 per cent of total United States direct investments, whereas utilities and transportation accounted for 47 per cent. At certain times the return on sugar investments has far outranked the income derived from all other investments; at others it has been nil.<sup>11</sup> The statistical determination of returns from sugar is made extremely difficult by the fact that numerous mills owned by corporations in the United States do not publish separate statements. In the case of others there are doubts as to the nationality of ownership. Returns on the approximately 138 million dollars of British investments can be estimated more reliably, since perhaps 80 per cent is represented by holdings in the United Railways of Havana, the distressing record of which is easily available. Returns on Spanish investments are something of a mystery, for while the investments of those Spaniards, who are residents of Cuba, may be larger even than United States investments, those owned by actual residents of Spain can only be guessed. Canadian investments amount to very little. A number of sugar mills have been listed as Canadian-owned, but

<sup>10</sup> Part II, pp. 247-264.

<sup>11</sup> The heavy losses that were sustained are not, of course, a balance of payments item.

their profits have been more in the nature of capital repayments, for they have served to reduce an indebtedness to the Royal Bank of Canada. Investments of other countries are insignificant.

It is evident from the foregoing that the yield on United States investments makes up by far the largest part of the returns on total foreign investments. The uncertainty surrounding the former therefore is necessarily reflected in the estimates of the latter. For the years up to 1936 these estimates must be regarded as extremely tentative; for 1937 and after they may be accepted with slightly more confidence.

For the years 1940-1945 an attempt has been made to take into account the effects of wartime shifts in the ownership of direct investments, such as of the sale of sugar properties by United States banks, as well as the restriction of remittances resulting from foreign funds control by the Cuban and United States governments. Some of the adjustments are highly tentative.

#### C. PERSONAL REMITTANCES

The Foreign Policy Association reports that until some time prior to 1934 the Spaniards of Cuba were believed to have remitted from 10 to 20 million pesos annually to their home country.<sup>12</sup> Although some investigators have regarded this estimate as vastly exaggerated, it is borne out to some extent by the large excess of bank remittances to Spain over Cuban imports from that country. An item of this magnitude has therefore been allowed for among the service accounts.

Adjustments have been made to account for the wartime restrictions on remittances to Spain, Occupied Europe, and the Far East. The rise in remittances by Cubans in 1945 reflects the relaxation of these restrictions and in particular the very heavy flow of personal remittances to China following VJ-Day.

The relatively greater size of receipts of personal remittances as compared with prewar years is largely due to the presence of political refugees who entered Cuba in great numbers during

<sup>12</sup> Foreign Policy Association, *Problems of the New Cuba*, p. 45.

1939 to 1942 in transit to the United States and who, in many cases, remained in the country for protracted periods.

#### D. TOURIST EXPENDITURES

The main component under this heading, expenditures of American travelers in Cuba, appears to have been considerably overestimated in the past. Even during the lush times of the 1920's, when money and liquor flowed freely on Cuban cruises, receipts from this source are not likely to have been much more than half of the 30 million dollars that Cubans have calculated.<sup>13</sup> The expenditures of Cuban travelers abroad, on the other hand, appear to have been underrated. The earlier estimates for both sides have been adjusted accordingly.

#### E. NEW INVESTMENT

To the extent that new investments were made out of funds derived from the sale of securities, information regarding this item is fairly satisfactory. It must be remembered, however, that in many cases securities were sold covering investments made some time previous and that often substantial profits were realized on such transactions, which did not accrue to the Cuban economy.<sup>14</sup> Large direct investments were made, on the other hand, which did not give occasion to public offerings and which are difficult to trace. There can be no doubt that during the twenties new United States investments in Cuba were substantial, particularly in the sugar industry. They probably were not so large, however, as the stated value of United States investments in Cuba would make them appear, for a good part seems to have been the result of reinvested profits and write-ups. The figures shown in the balance of payments include the various loans made to the Cuban government.

Following the year 1930 there is no evidence of net new in-

<sup>13</sup> *Cuba Económica y Financiera*, February 1933, p. 1.

<sup>14</sup> The sale of securities on the basis of earlier investments has nothing to do, of course, with the view held by some economists that international lending is more usually the result than the cause of a disequilibrium in the balance on current account. In Cuba this view does not appear to find corroboration, except perhaps in the case of the 1923 Morgan loan. See William Adams Brown, *The International Gold Standard Reinterpreted* (New York, 1940), I, 539-549.



vestments until the outbreak of World War II. It is quite possible that during the early part of the depression United States corporations transferred funds to Cuba to finance the losses suffered by their subsidiaries, but it is also likely that sizable depreciation allowances were withdrawn and not reinvested. Whereas the practice of throwing good money after bad probably came to an end after 1932, the process of disinvestment and the export of amortization reserves presumably continued. One may suspect that a good part of the residual item which appears in the balance of payments during the thirties is accounted for by such withdrawals. It has not been possible, however, to make an estimate of the amounts involved.

New investments by United States corporations, private persons, and the United States government, together with the acquisition by Cuban citizens of external Cuban dollar bonds, accounted for the great bulk of long-term capital movements during the war years. The figures shown are based on Department of Commerce estimates of those movements. Lack of data made it impracticable to estimate long-term capital movements to and from other countries but they are not believed to have been very significant and may well have canceled out on balance.

#### F. SINKING FUND

The item shown under this heading represents amortization of the external public debt through sinking fund operations. Data on short-term capital movements, apart from changes in banks' balances abroad, are so fragmentary, particularly in the 1920's, that no attempt was made to account for them under a separate heading. There is no doubt, however, that short-term capital movements were an important item, and they account for a substantial part of the residual.

#### G. INTERNATIONAL RESERVE MOVEMENTS

The items shown under this heading are gold, dollar notes, and subsidiary currency, and banks' foreign balances. The data on gold and currency movements were taken from the tables showing the composition and origin of the money supply;

their composition was described in connection with the analysis of monetary developments. The movements in the banks' foreign balances are included in the total rather than treated as an autonomous short-term capital item, because such movements are largely induced, as pointed out in the chapter on bank policies. For the decade 1921-1930 no records of these movements are available.

#### H. RESIDUAL

While the large size of this item in the early twenties is chiefly due to the very rough estimates that had to be resorted to for this period, the -83.4 million figure for 1942 calls for special comment. During that year widespread German U-boat activities in the Caribbean prevented Cuba from shipping more than a relatively low proportion of her disposable sugar crop to the United States. This is reflected in the small favorable balance on merchandise account for that year. However, payment for a large percentage of the crop—even though the latter was not actually shipped abroad until the next year—was made in 1942, as reflected under the heading of "International Reserve Movements."

#### 3. THE BALANCE OF PAYMENTS IN 1946 AND 1947

The original estimate of the balance of payments in 1946 and 1947 was made by the Dirección General de Estadística under the technical direction of Dr. José Antonio Guerra, and was published in pamphlet form by the Ministerio de Hacienda. Detailed explanatory notes on the estimating techniques employed and the significance of individual items can be found there, as well as in the notes on the estimate as revised by the International Monetary Fund in its 1948 Year Book. Table 19 is based on this revised estimate.

Some of the items are somewhat uncertain and need a short discussion.

#### A. FOREIGN TRAVEL

The Cuban estimate shows surprisingly large *net payments* on this account, amounting to 18 million dollars in 1946 and

TABLE 19

THE CUBAN BALANCE OF PAYMENTS, 1946 AND 1947  
(In millions of pesos)

|                                                  | 1946  |        |         | 1947  |        |         |
|--------------------------------------------------|-------|--------|---------|-------|--------|---------|
|                                                  | Recd  | Paid   | Bal     | Recd  | Paid   | Bal     |
| Current Account                                  |       |        |         |       |        |         |
| Merchandise trade <sup>a</sup>                   | 534.6 | 300.4  | +234.2  | 772.7 | 519.9  | +252.8  |
| Shipping                                         | 1.6   | 24.6   | -23.0   | 0.8   | 34.6   | -33.8   |
| Insurance                                        | 0.2   | 2.8    | -2.6    | 0.3   | 3.4    | -3.1    |
| Commercial, financial, and professional services | 9.7   | 3.4    | +6.3    | 21.7  | 3.4    | +18.3   |
| Foreign travel                                   | 16.3  | 34.3   | -18.0   | 21.9  | 53.2   | -31.3   |
| Private remittances                              | 2.2   | 10.4   | -8.2    | 1.7   | 11.0   | -9.3    |
| Government transactions                          | 1.5   | 7.8    | -6.3    | 1.7   | 3.9    | -2.2    |
| Investment income                                | 1.6   | 41.9   | -40.3   | 1.0   | 75.0   | -74.0   |
| Return on direct investments                     | (0.3) | (34.7) | (-34.4) | (0.2) | (64.3) | (-64.1) |
| Return on portfolio investments                  | (1.3) | (7.2)  | (-5.9)  | (0.8) | (10.7) | (-9.9)  |
| All service items                                | 33.1  | 125.2  | -92.1   | 49.1  | 184.5  | -135.4  |
| Total Current Account                            | 567.7 | 425.6  | +142.1  | 821.8 | 704.4  | +117.4  |
| Autonomous Capital Items                         |       |        |         |       |        |         |
| Direct investments                               |       |        | -4.0    |       |        | -4.6    |
| Portfolio investments                            |       |        | -6.5    |       |        | -5.8    |
| Official loans                                   |       |        | +5.4    |       |        | 0       |
| Official amortization                            |       |        | -6.3    |       |        | -6.7    |
| Subscription to IBRD and IMF                     |       |        | -0.7    |       |        | -12.5   |
| Total Autonomous Capital Items                   |       |        | -12.1   |       |        | -29.6   |
| International Reserve Movements                  |       |        |         |       |        |         |
| Gold                                             |       |        | -35.0   |       |        | -53.0   |
| Dollar notes and subsidiary currency             |       |        | -20.1   |       |        | -33.0   |
| Foreign balances of nonbank public               |       |        | -22.3   |       |        | +25.7   |
| Banks' foreign balances                          |       |        | -21.5   |       |        | -15.3   |
| Total Reserve Movements <sup>b</sup>             |       |        | -98.9   |       |        | -75.6   |
| Residual                                         |       |        | -31.1   |       |        | -12.2   |

<sup>a</sup> Recd : dollars/pesos received by Cuba Paid : dollars/pesos paid by Cuba Bal : balance.

<sup>b</sup> + : loss of reserves - : gain in reserves

31.3 million in 1947. These large net payments can be largely attributed to the assumption that, apart from the banks' purchases and sales of exchange in connection with foreign travel,

the average foreign visitor brought \$100 in cash into the country while the average Cuban traveling abroad carried \$400 with him. It is noteworthy that the United States Department of Commerce, in compiling a bilateral balance of payments between Cuba and the United States for 1946 and 1947, estimated on the basis of questionnaires that tourist expenditures by Americans in Cuba amounted to 13.1 million dollars and those of Cuban tourists in the United States to 11.2 million in 1946. The respective figures for 1947 were 19.2 million and 21.4 million dollars. An improvement of the estimate will have to await the development of more adequate sampling techniques.

#### B. RETURN ON DIRECT INVESTMENT

This item was derived by taking the estimated difference between the dollar proceeds of exports and the production costs of the branches and subsidiaries of foreign firms operating in Cuba. Adjustment does not appear to have been made for re-invested earnings. The United States Department of Commerce reports that the *gross* income returns on the direct investments of United States firms operating in Cuba amounted to 54.4 million dollars in 1945 and 76.5 million dollars in 1947, but that 20.9 million dollars of the 1946 earnings and 39.5 million dollars of the 1947 earnings were reinvested in the country.

#### C. DIRECT INVESTMENT

The only item included under this head is depreciation reserves "presumably maintained abroad" by head offices and not remitted to Cuba. The United States Department of Commerce reports that in 1946 United States investors (mostly banks) sold 11 million dollars' worth of their sugar investments, and one million in 1947. In view of the failure of the Cuban estimates to exclude reinvested earnings from earnings on direct investment, it would probably be appropriate to include them as new direct investments. It is also known that Cuban individuals invested rather heavily in Florida real estate during the last three years, but no indication of the size of these investments is available.



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