Euler Hermes Economic Research

Economic Insight

Cuba: Viva la (economic) Revolution

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Executive summary

- Three game changers for Cuba: (i) the progressive easing of the economic restrictions by the U.S.; (ii) a new Cuban law promoting foreign investments; and (iii) the launch of the 'Cuba Portfolio of Opportunities for Foreign Investment', worth USD15bn across 246 projects.
- Real GDP growth is expected at +2.1% in 2015, before strengthening on average to +5-6% over 2016-2020, with investment being the main driver.
- Expected impact include additional imports of USD2bn per year, of which +USD800mn for Machinery and Equipment, +USD500mn for energy, +USD350mn for Manufactured Goods and +USD200mn for Chemicals. The U.S. will be the main winner, with USD1bn export gains expected per year, becoming Cuba's main trade partner as of 2018.
- However, important risks will remain. The multiple exchange-rate system will increase currency, financing and credit risks, while the business environment will remain highly adverse.

Three game changers for Cuba

Game changer #1: The easing of economic restrictions imposed by the U.S.

The removal of Cuba from the U.S. "States Sponsors of Terrorism" list (SSOT list) at the end of May 2015 and the subsequent easing of the economic restrictions (embargo) imposed by the U.S. are undoubtedly the most critical game changers for the Cuban economy. They will boost trade with the U.S and greatly improve the access to foreign financing. Although the complete lifting of the embargo requires a vote in Congress, we expect the restrictions to continue easing throughout the remainder of Obama's mandate (ending January 20, 2017).

Game changer #2: The new law for foreign investment

Though some clauses remain highly constraining, and control by the State is to remain prominent, the new law adopted in March 2014 provides a much more favorable and pragmatic framework than the previous 1995 regulations for foreign investment, especially in the Mariel Free Trade Zone.

Game changer #3: New investment opportunities

In November 2014, the Cuban government presented a vast wish-list of projects offered to

Table 1
Main official investment opportunities in Cuba by sector

	Number of projects	Estimated investment amount (USD mn)
Total	**246**	**15201.5**
Outside the Mariel Zone	**221**	**13588.7**
Agri-food	32	711.6
Sugar industry	4	160.0
Industry	10	3118.1
Construction	6	916.5
Transportation	3	49.1
Toursim	56	1029.3
Retail	1	8.7
Renewable energy	13	7595.5
Oil	86	Non-specified
Mining	10	Non-specified
In the Mariel Zone	**25**	**1612.8**
Biotech + Pharma	13	860.0
Industry	6	378.0
Agro-industry	5	374.8
Energy	1	Non-specified

Sources: Cuban government, Euler Hermes estimates foreign investors. The ‘Cuba Portfolio of Opportunities for Foreign Investment’ includes 246 projects seeking over USD15bn dollars of capital (Table 1). It covers critical sectors for the Island such as energy, food, construction, pharmaceuticals and biotechnology, and others, while giving a particular emphasis on developing the Special Zone of Mariel. The Mariel Bay (which is 45km west of La Havana, and only 180 km from Florida) is hoped to become a major cargo traffic hub. The site will include a vast free-trade zone and a container port able to host some of the world's largest cargo ships. By offering particularly low-tax and low-regulation, the government expects to attract enough foreign capital to build industrial factories and enlarge import-export services in the Mariel Zone. The extension of the Panama Canal and the development of the Nicaragua Canal may also further bolster success.

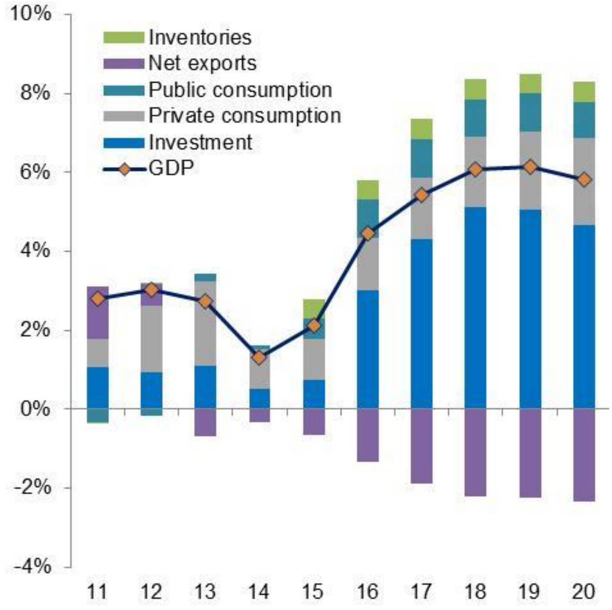
Economic boost with large external financing needs

This new landscape will give a tangible boost to the Cuban economy. Expected at +2.1% in 2015, real GDP will accelerate to 5-6% growth per year over 2016-2020, compared with an average of 2% over the past 5 years (Chart 1). Activity will be driven mostly by investment, which we anticipate to grow by 15% - 20% in the coming years. Consumption should also accelerate but to a lesser extent, as the internal market will continue to be highly State-driven and ration based. The easing of the embargo and opening up the U.S. Market to Cuban products would greatly sustain exports. We expect them to gain momentum gradually in coming years as investment generates additional production capacity in export-oriented sectors.

Additional exports, consumption, and especially additional needs in capital goods will support imports of goods and services, potentially rising up to +20% per year in real terms. Specifically, we estimate that imports of Machinery and equipment could increase on average by +20% per year over 2015-2020, representing close to 30% of total imports by 2020. This will generate on average +USD800mn additional imports per year. Stronger activity dynamism show larger energy needs, increasing import of fuels by +USD500mn per year on average, while higher domestic consumption would generate additional manufactured articles imports of +USD350mn. Similarly, developments of biotechnology and pharmaceutical industries, which are already important in Cuba, would support imports of Chemicals up to +USD200mn per year (Chart 2).

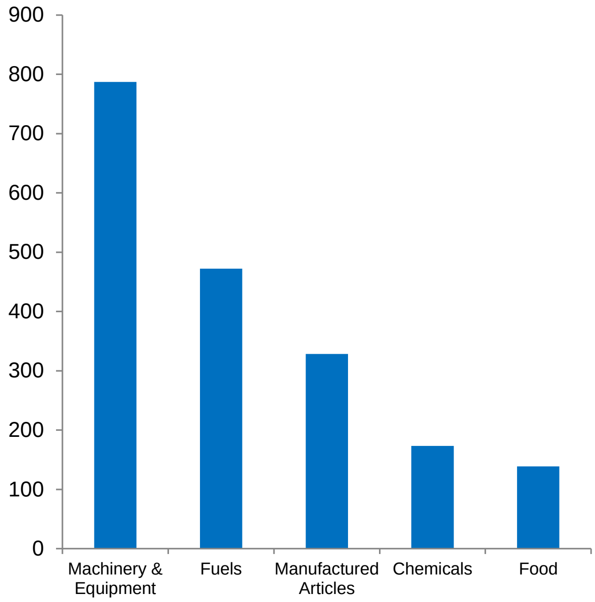
The boost in imports will see the trade deficit peak at -18% of GDP in 2018, before declining progressively thereafter, thanks to more moderate import growth coupled with the sustained increase in exports as industries

Chart 1
Real GDP growth and breakdown (%)



Sources: Cuba Institute of Statistics (ONEI), Euler Hermes estimates and projections

Chart 2
Yearly average additional imports of selected items over 2015-2020 (USD mn per year)



Sources: Euler Hermes projections

expand and mature. Similarly, the surplus in the balance of services (estimated at 15% of GDP in 2014) will narrow drastically between 2015-2018 as imports will increase much more rapidly than the additional revenues coming from tourism. Larger tourism revenues would come in the first stage following the end to the embargo, as U.S. citizens can now freely visit the Island, alongside increasied investments in the tourism sector. The balance of income, which was in a deficit of -1.6% of GDP in 2014, will record a constant surplus over the next few years thanks to increased remittances sent by Cubans from abroad, especially from those living in the U.S. (the easing of the embargo increased the amount of remittances allowed to be sent by Americans to Cuba). The current account balance - which is estimated to have recorded a surplus of +1.8% of GDP in 2014 - would shift into a deficit of -6% in 2016. The deficit could widen though in 2018 to -15%, before diminishing again to -10% of GDP by 2020 (Chart 3). The external deficit will be partly financed by FDI inflows, which could reach USD2.5bn per year, and to a lesser extent by local capital and national monetary reserves. The rest of the deficit will be financed by the increase in external debt, which could more than double by 2020 to 40% of GDP.

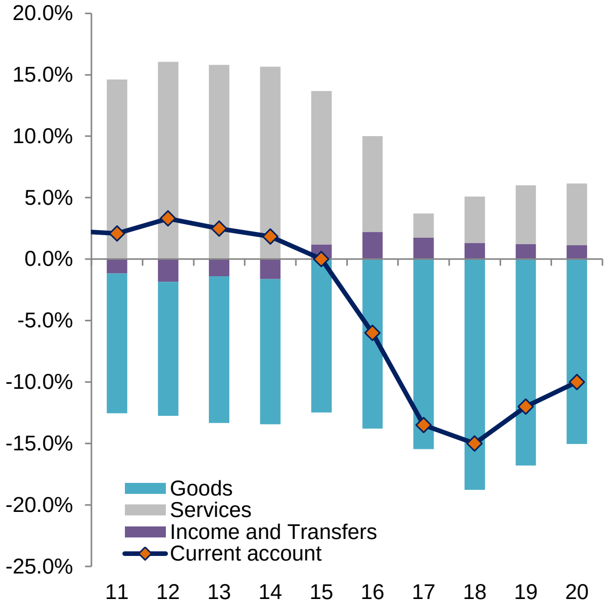
Winners and losers

It should come as no surprise that we expect the U.S. to be the main winner from lifting the embargo. We estimate U.S. exports to Cuba to increase on average by +USD1bn per year, reaching around USD6bn in 2020 and implying a roughly 25% market share, against one of approximately 3% today (chart 4). Traditional partners will also benefit strongly: China could see its exports to Cuba increase by +USD360mn per year, Spain by +USD200mn, Brazil by +USD120mn and France by +USD100mn.

Venezuela, currently a major trade partner of Cuba who focuses on oil and petroleum exports, will be the main loser as: (i) Given the problematic financial situation of Venezuela, we expect the country to reduce the Petrocaribe Program, which allows Central American countries, such as Cuba, to buy Venezuelan oil at preferential rates; (ii) It is very likely that Cuba will diversify the origins of its energy imports, looking more towards the U.S. and Mexico, and potentially other Latin American countries (Brazil); (iii) Cuba has 124mn barrels of proved oil reserves that should begin to be extracted by 2018. We expect both the market share and the value of Venezuelan exports to diminish greatly, falling roughly from USD5.4bn today to USD1.5bn by 2020.

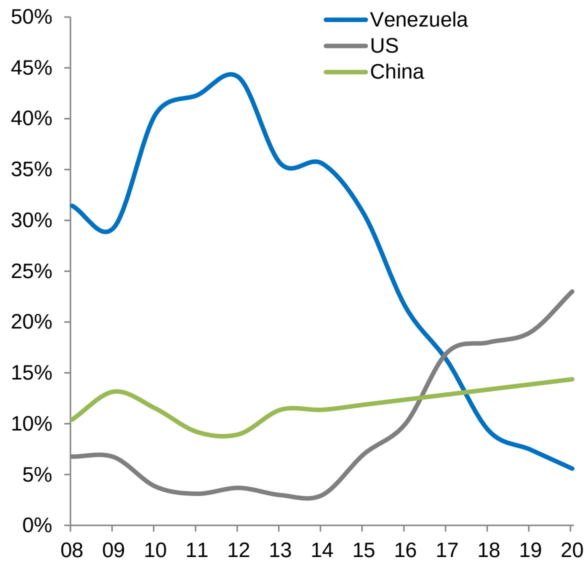
Other Caribbean regions will be also face challenges as a result of the changes in Cuba. The tourism activities in other islands will be certainly affected, while countries with Free Trade Zones (Panama, Dominican Republic, Jamaica) will be will find new competition in the development of the Port of Mariel.

Chart 3
Current account breakdown
(% of GDP)



Sources: Cuba Institute of Statistics (ONEI), Euler Hermes estimates and projections

Chart 4
Market share in Cuban imports
(% of total imports)



Sources: Cuba Institute of Statistics (ONEI), Euler Hermes estimates and projections

Three main risks will remain

Risk #1: Currency and financing risks will increase. The Cuban exchange rate system is complex, featuring two coexisting official currencies (the CUP and the CUC) with different (fixed) exchange rates (Chart 5). The government has already expressed its will of unifying the exchange rate system. However, no concrete steps have been taken, as unification might lead to drastic economic adjustments, with high economic and social costs. In the long-run, however, a unification would be unavoidable with the opening of the economy, as the increase of foreign tourist arrivals (bringing USDs) and capital inflows might further develop the black market for hard currency and increase the dollarization of the economy, pushing the country sooner or later towards a currency collapse. In addition, financing the real economy, especially access to credit for companies will remain limited in the short-run as the interbank payment system and distribution channels need to be reestablished.

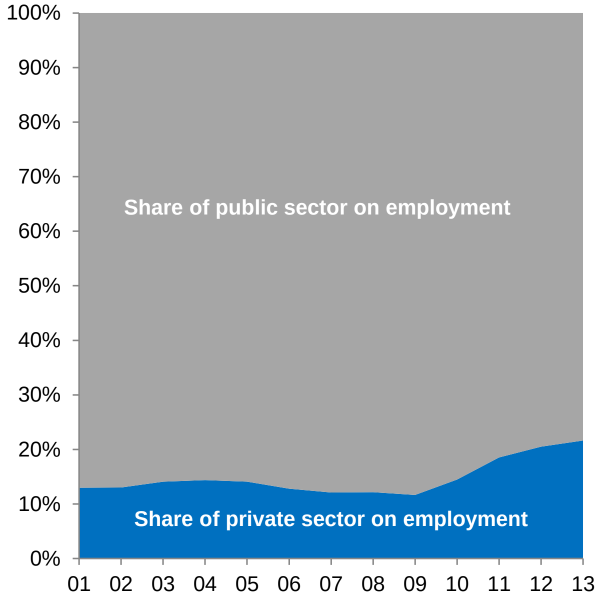
Risk #2: Political and business climate risks to remain high. The desired 'upgrade [of] the Cuban economic model' by President Castro will require strong support from the Party. The possibility of political and social tensions, as well as full-fledged protectionism along the way cannot be ruled out, especially after the 2018 elections, when Raul Castro committed to step down. Foreign investments will remain tightly controlled by the State, with most foreign ventures requiring majority Cuban ownership while large government holding companies will continue to dominate the market. Despite the positive developments, the Cuban economy will remain rationed and mostly State-driven, as labor, wages and price controls will remain in place. The development of the private sector will only be very gradual, as the public sector accounts for ¾ of the labor force (Chart 6). Workers in the projects are expected to be mostly filled by Cuban nationals employed and paid by a local public employment company.

Risk #3: Credit risk to be watched intensely
In the short-run, non-payment risks by Cuban companies will remain high. Euler Hermes rates Cuba D4 when it comes to getting paid.

Chart 5
Exchange rate system and currencies

Sources: Central Bank of Cuba, Euler Hermes

Chart 6
Labor force distribution
(% of total)



Sources: Cuba Institute of Statistics (ONEI), Euler Hermes estimates and projections

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