SENDING THE RIGHT SIGNALS: USING RENT-SEEKING THEORY TO ANALYZE THE CUBAN CENTRAL BANK

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A citadel of socialist values, the Cuban economy has resisted the global trend of neoliberal financial reform that has swept through other developing countries. As part of a modest liberalization of the finance sector during the 1990s, however, the Cuban government established the Cuban Central Bank in 1997.[1] In the context of central bank governance, the neoliberal trend in developing countries has been toward increased formal and substantive central bank independence from executive oversight.[2] The Cuban Central Bank bucks that trend. In the United States, academic interest in legal aspects of the Cuban economy is growing in tandem with its selective liberalization, despite onerous federal governmental constraints on these studies. This Article contributes to this literature by exploring the impact of financial signaling by the Cuban government on decisions by prospective foreign investors on whether to invest in Cuba. In doing so, this Article asserts that Cuba could rehabilitate its market credibility deficit and mitigate the effect of its legal disabilities under U.S. law through collateralized debt transactions in the open market and through monetary reforms.

This Article considers how central bank governance structure operates as an investment signal to potential foreign investors with respect to the term of their potential investments. Although rejecting the conventional explanation that central bank independence signals low inflation, this discussion shows that central bank independence does send a favorable investment

1. *See* BANCO CENTRAL DE CUBA, *at* http://www.bc.gov.cu/english/home.asp (last visited Apr. 10, 2005).

2. Heidi Mandanis Schooner, *The Role of Central Banks in Bank Supervision in the United States and the United Kingdom*, 28 BROOK. J. INT'L. L. 411, 434 (2003).

signal because independence shows official openness to opportunistic deal making (rent-seeking)[3] with financial firms for a longer term than deals possible with a dependent central bank. It further shows that the Cuban Central Bank is not independent and hence, does not send a favorable investment signal to financial firms considering investment with respect to term. Recognizing that proper financial signals induce foreign investment, this Article proposes that Cuba may replicate some of the signaling value of central bank independence through issuing collateralized government securities. This Article recommends complementary reforms to the Cuban and U.S. governments that would increase the Cuban Central Bank's financial signaling capabilities.

Part I suggests that the signaling value of central bank independence in developing countries reflects the value of potential rent-seeking between foreign investors and officials, rather than expectations of low inflation. Part II describes Cuba's access to foreign financing in the form of foreign direct investment and credit flows and explains how Cuban monetary policy has inhibited increased foreign financing. Part III explains how the governance structure of the Cuban Central Bank signals that the institution is not formally or substantively independent of oversight from other governmental actors. Part IV urges the Central Bank to issue collateralized governmental debt to replicate—albeit only at the transactional level—some of the signaling benefits of central bank independence. To complement this proposal, Part V identifies crucial changes to U.S. law which could improve Cuba's capacity to manage its public financing on market terms. Part VI concludes by inviting other scholars to encourage constructive discourse on Cuban credit market structure.

I. METHODOLOGICAL CONTRIBUTIONS TO LEGAL SCHOLARSHIP

This Part explains the meaning of central bank independence as a signaling device for ensuring compliance across time with bargained-for expectations of government officials and po-

3. *See* discussion about rent-seeking *infra* Part I.B.

litical and market constituencies. The idea that central bank independence attracts foreign investment to developing countries by signaling low inflation is incorrect. Signaling refers to an intentional message sent by party A—typically about party A's future behavior——to party B in order to influence party B's behavior with respect to party A.[4] The signaling considered here refers to deliberate regulatory and market actions taken by the Cuban Central Bank (Central Bank) observable to international asset holders on the lookout for attractive investments.[5] Instead of signaling low inflation, independence may reflect a political economy in which private creditor interests influence central bank design with respect to the term of financial arrangements. The upshot of this view for the Central Bank is that it will not become independent until the development of a private creditor class capable of promoting its term and other balance sheet in-

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4. For a general discussion of signaling theory and its origins in labor market analysis, see L. PHLIPS, THE ECONOMICS OF IMPERFECT INFORMATION 122–28 (1988). If potential counterparties had relatively perfect information about each other, the benefits of signaling would be limited. In the context of information asymmetry, though, in which a counterparty struggles to glean meaningful information with which to assume financial risk, signaling may provide a basis for risk taking, albeit with imperfect information. Michael Spence, *Signaling in Retrospect and the Informational Structure of Markets*, AM. ECO. REV. 434, 434 & n.1 (June 2002).

5. Of course, the impact of this investment signal varies with the liquidity of the foreign investment. Consider the following example: assume a foreign investor invests in a factory, a form of investment that is not liquidated easily or quickly. A signal from the central bank in the country where the factory is located may not influence whether she increases or decreases her investment because the transaction costs of reallocating the capital in the factory are high (that is, she cannot exit her position intraday). Now, assume a foreign investor is holding foreign bonds with a liquid secondary market. A central bank signal to this investor will impact him more because, given the secondary market, he can increase or decrease his securities position readily (net transaction costs of course). In terms of its liquidity and exit transaction cost, a bank loan stands between the direct investment and the security. *See* SYLVIA MAXFIELD, GATEKEEPERS OF GROWTH: THE INTERNATIONAL POLITICAL ECONOMY OF CENTRAL BANKING 35–44 (1997) [hereinafter MAXFIELD, GATEKEEPERS OF GROWTH]. Moreover, an independence signal means one thing to domestic creditors of a developed country and another thing to foreign creditors of a developing country. The difference may rest on the fact that developed countries with stable currencies rely more on domestic savings from creditors interested in the price stability of the national currency. Developing countries, though, have less domestic savings and must look to foreign creditors, who may care less about the price stability of the national currency because their obligations are often denominated and settled in foreign exchange (that is, in a currency other than that of the borrower).

terests through lobbying the public sector.

A. A Deflationary View of Central Bank Independence

The central bank independence hypothesis claims that a central bank not accountable to elected officials is better at setting interest rates, which in turn impact present consumption, employment rates, the business cycle, and inflation.[6] According to the hypothesis, interest rates are best determined on the basis of a medium-term rather than short-term horizon.[7] Reducing interest rates increases present consumption and creates short-term economic prosperity (and risks inflation).[8] When elected officials control the central bank, interest rate determinations reflect the short-term survival strategies of self-interested incumbents exposed to the recurring risk of removal on Election Day. In the interest of self-preservation, elected officials may reduce interest rates before Election Day to create well-timed, albeit short-lived, prosperity.[9] When central bank

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6. C.A.E. GOODHART, THE CENTRAL BANK AND THE FINANCIAL SYSTEM 63 (1995). Monetary policy focuses on controlling inflation. Bank of England & The Times, *How Do Interest Rates Affect Inflation?,* TARGET TWO POINT ZERO, *at* http://www.bankofengland.co.uk/targettwopointzero/inflation/ratesAffectInflation.htm (last visited Apr. 10, 2005). "Cheap" money (that is, low interest rates) encourages consumer demand. Price increases in the cost of goods, and services erode the purchasing power of the currency. Linda Boelter, *Latest Fed Interest Rate Decisions Affect Consumers*, UW-EXTENSION, June 22, 2001, *at* http://www.umex.edu/news/story.cfm/346. Increased demand for goods and services raises their prices and contributes to inflationary pressure. Bank of England & The Times, *supra*. In contrast, raising interest rates reduces inflationary pressure and, all else being equal, increases the purchasing power of the currency. *Id.*

7. GOODHART, *supra* note 6, at 67.

8. *Id.* at 61.

9. Market analysts, and presumably investors, know the rules of the game. Consider this excerpt from an article on central banks in Latin America:

> Elections are traditionally a time when monetary policies are loosened in Latin America. During the past two Mexican presidential elections, for example, the country has had an economic crisis. However, Rojas Suarez[,] [Chief Economist for Latin America at Deutsche Bank,] points to the greater stability during elections as a further sign of the greater monetary stability in the region. "Governments always used to resort to the printing machine," she said. "But you won't see that this year with the elections in Argentina. And I really don't think it will happen in Mexico, either."

Michael Peterson, *Developing an Independent Streak: Central Banks in Latin America* governors with long tenures determine monetary policy free of interference by elected officials—so goes the hypothesis—the central bank sets rates with better regard for long-term growth prospects. According to the independence hypothesis, monetary policy, so structured, will produce better inflation outcomes and optimize social welfare.[10] Independence mechanisms can range from fully self-binding to minimally self-binding.[11]

As developing countries restructure their financial sectors to attract more foreign capital, reform has been toward greater central bank independence.[12] Proponents of the central bank independence hypothesis assert that independence leads to good inflation outcomes and it is the anticipation of this inflation outcome that foreign investors may find appealing.[13] However, the

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Are Gaining Greater Autonomy While Succeeding at Controlling Inflation, LATINFINANCE, Sept. 1999, at 24.

10. One scholar has argued that Latin American governments in particular should strive for increased central bank independence. Juscelino F. Colares, Note, *Formal Legal Theory and the Surrender of Political Control Over Monetary Policy: What Can Ulysses' Journal to Ithaca Teach Argentina About Appropriate Legal Farm?*, 36 CORNELL INT'L L.J. 151, 175 (2003):

> [t]he final credit for the choice of appropriate form in the monetary policy arena should go to the mature democracies of the West. Indeed, for so far only they have been able to engineer an institutional design that prevents the polity from being overwhelmed by the opportunistic pursuit of short-term political gain . . . Western democracies have shown that the challenge for less mature democracies of Latin America and elsewhere is to divert democracy from its tendency to distort public policy from long- to mere short-term electoral goals.

Id.

11. *See* Marta Castello-Branco & Mark Swinburne, *Central Bank Independence*, 29 FIN. & DEV. 19 (1992). See *infra* Part IV for a description of collateralized debt as a transactional rather than an institutional form of independence.

12. *See* MAXFIELD, GATEKEEPERS OF GROWTH, *supra* note 5, at 35. The following remark in connection with the Brazilian Central Bank is typical of the emerging market foreign investment literature: "Legislation granting the nominally autonomous Central Bank full independence to set short-term interest rates would further increase confidence in the depth and sincerity of the government's commitment to a market-based economy." *The Growth Challenge*, LATINFINANCE, Sept. 2003, at 37–38. Understandably, establishment of a central bank has been identified as one prerequisite institutional element for a market economy in Cuba. *See* CUBA AT A CROSSROADS: POLITICS AND ECONOMICS AFTER THE FOURTH PARTY CONGRESS 249, 253 (Jorge F. Pérez-López ed. 1994) [hereinafter CUBA AT A CROSSROADS].

13. *See* MAXFIELD, GATEKEEPERS OF GROWTH, *supra* note 5, at 36. By promising to preserve asset values, so the corollary goes, an independent central bank reassures the

view that foreign investors read independence as a proxy for good inflation outcomes engineered by an apolitical central bank has recently come under sustained attack. Empirical evidence links independence with good (that is, low) inflation outcomes, not in developing countries, but only in more developed countries, which rely more on domestic savings and credit than on foreign financing.[14] Foreign investors in a developing country know, therefore, that not mere independence will protect their investments from loss due to ensuing inflation.

Why then would a developing country's government claim that increasing the independence of its central bank would signal creditworthiness to international asset holders? The answer lies not in the inflation correlation of independence but in viewing central bank independence as a long-term deal between officials and the financial sector, that is, rent-seeking.[15] The fol-

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investor about her returns.

14. Independence has been correlated with low inflation in industrialized countries. *See* Joe Peek et al., *Is Banking Supervision Central to Central Banking?*, 114 Q.J. ECON. 629 (1999). However, no such correlation exists between formal legal independence and inflation in developing countries. Sylvia Maxfield, *Financial Incentives and Central Bank Authority in Industrializing Nations*, 46 WORLD POL. 556, 557 (1994). After reviewing statistical data de-linking central bank independence from low inflation outcomes, Maxfield puts it this way, "[i]f legal independence does not necessarily explain the likelihood of successful anti-inflationary efforts by a central bank, one needs to look elsewhere for an explanation of central bank behavior and capacity." *Id.* She claims that it is the central bank's networks and reputation—and not formal independence—that ultimately allow a central bank to control inflation:

> The central bank's effective exercise of authority to prevent inflation requires a special relationship with potential proponents of expansionary policy *that is not well characterized as independence*. The respect other government officials and political leaders have for central bank policy positions may be founded upon close social and/or political relations rather than upon the bank's independence or autonomy.

Id. at 558 (emphasis added). Although this argument focuses on the deployment of central bankers' social capital to reduce inflation, this same capital is fallow ground for rent-seeking. *See* discussion *infra* note 15 and accompanying text.

15. Economists refer to this type of deal making as "rent-seeking." Rent-seeking refers to the extraction of value through manipulation of the economic and legal environment with means other than the investment or labor in a competitive market. I use the term here to refer to deal making between government officials with discretion over economic regulation and the self-interested market participants affected by this economic regulation. Gordon Tullock of the George Mason University School of Law introduced the concept of rent-seeking in a seminal 1967 article in connection with the wel-

lowing Part will further explain the rent-seeking argument.

B. Using Rent-Seeking Analysis to Track Creditor Influence on Government Design

Among regulatory processes, central banking is especially suited for rent-seeking—and concomitantly rent-seeking analysis—because a central bank is perhaps the only government actor that performs its regulatory functions on the market by transacting *in* the market again and again.[16] Hence, an ideal forum for deal making is created between officials and market participants, for whom each interest rate determination is an opportunity to make a deal, monitor prior deals, or retaliate for breach. Seen this way, commercial banks in the United States seek rents happily by pressing their dynamic preferences about the discount rate through the Federal Open Market Committee.[17] More generally, rent-seeking provides a critical perspec-

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fare costs of rent-seeking. *See* Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Thefts*, 5 W. ECON. J. 224, 224–32 (1967); Gordon Tullock, The *Origin Rent Seeking Concept*, 2 INT'L J. BUS. & ECON. 1 (2003) (clarifying the provenance of his idea). Obviously, by endorsing activity to signal rent-seeking, this Article considers the potential welfare gains of rent-seeking.

16. Purchasing government securities in the open market to influence interest rates epitomizes this merger of regulatory function and market action. For example, in the United States, government securities open market operations are a tool of monetary policy. THE FEDERAL RESERVE BOARD, OPEN MARKET OPERATIONS 35–42, THE FEDERAL RESERVE SYSTEM PURPOSES AND FUNCTIONS, *at* http://www.federalreserve.gov/pf/pf.htm (last visited Apr. 10, 2005). Open market operations involve the purchase and sale of government securities in public markets in order to impact the amount of liquidity in the banking system. *Id.* at 35. A central bank absorbs liquidity from the banking system by selling government securities from its portfolio of securities. *Id.* at 36, 39. These transactions impact the credit supply in the banking system. *Id.* at 35–36. For example, selling government securities to banks absorbs their excess liquid resources and thereby reduces the amount of available credit. *See id.* at 36. Conversely, buying government securities from bank portfolios adds liquid resources to the banking system and, hence, increases the credit capacity of banks. *Id.* at 35. For the Central Bank to participate in open market operations, the State Council would have to clarify whether the Central Bank may conduct open market operations in government securities. At present, the Central Bank may not directly purchase government securities. *See* DECRETO-LEY 172 art. 20 (1997) (Cuba).

17. The discount rate is the overnight rate charged by the Federal Reserve to banks seeking collateralized short-term or agricultural credit. The base rate from which other market interest rates derive, the discount rate determines the prospective cost of money (banks' main factor input) and the price risk of fixed-rate assets and liabilities.

tive from which to view banking history, such as how the U.S. Federal Reserve System became independent of the U.S. Treasury.[18]

Rent-seeking is particularly useful for analyzing foreign investment in developing countries because neoliberal conventional wisdom advocates a tight nexus between authorities and market participants during the construction of a country's financial infrastructure.[19] Rent-seeking is also more relevant in a

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For an excellent discussion of discount window operations in the United States, see DAVID L. MENGLE, INSTRUMENTS OF THE MONEY MARKET 23–35 (1986) for an excellent discussion of discount window operations in the United States. As noted, the Federal Open Market Committee seamlessly integrates commercial bank money preferences into rate setting:

> Contrary to popular opinion in the United States, interest rates are not set by the Board of Governors (BOG) of the Federal Reserve System (Fed), but by the Federal Open Market Committee (FOMC), that includes the BOG as well as the presidents of twelve privately-owned regional Federal Reserve Banks . . . If the regional bank presidents who sit on the FOMC are not accountable to Congress or the President, then to whom are they accountable? To which constituencies? By law, they are accountable to the private commercial banks that own the shares of each regional Federal Reserve Bank.

See Timothy A. Canova, *Financial Liberalization, International Monetary Dis/order, and the Neoliberal State*, 15 AM. U. INT'L L. REV. 1279, 1295–96 (2000).

18. Milton Freidman describes how the Federal Reserve System gained its independence in monetary policy from the Department of the Treasury in the Treasury-Federal Reserve Accord of 1951. MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867–1960 623–27 (1963). Between 1941 and 1951, the U.S. Treasury directed the Federal Reserve to prop-up the government securities market to reduce the government's borrowing costs, hence easing war-related financing. *Id.* at 546–91, 596–601, 610–12. In 1951, the Treasury and the Federal Reserve reached an agreement providing that the Federal Reserve would no longer actively support the Treasury's borrowing rate by buying Treasury securities. *Id.* at 623–24. Although Friedman does not address the microeconomic incentives of the institutions involved, rent-seeking could also explain the birth of the Accord. During the war years and afterwards, financial firms had accumulated surpluses thanks to government-engineered low interest rates. These firms faced the risk that a future government might abandon this rate policy or—worse still—increase interest rates, which would increase funding costs and reduce asset values. Placing the timing of the Accord in the context of commercial banks' self-interest regarding their then balance sheets, that is, applying a rent-seeking approach to the events described by Friedman, suggests that these firms had a strong financial interest in reducing inflation. As a result, these firms would have preferred to see interest rate determinations made by a rate setting mechanism, that is, the Federal Reserve System, to which these firms had access through relationships with the Federal Reserve member bank, rather than by elected officials.

19. In this sector, the International Monetary Fund (IMF) exercises the greatest

political economy—like Cuba's—in which the government commands economic ownership and production.[20]

An academic authority on central banking has forcefully argued how rent-seeking may contribute to the emergence of independence in central bank governance.[21] An independent central bank represents a loss of executive discretion to politicians who could otherwise exploit interest rate setting for their own career (or other) interests.[22] Self-serving politicians would sacrifice such a valuable right only because the establishment of an

normative power in articulating and enforcing the design and operation of central banking in developing countries. Consider how the following exhortation towards active government involvement in planning the financial sector necessarily requires close negotiations with market participants:

> [T]he authorities—debt manager, central bank, and the regulatory authority—should play an active role in fostering the development of efficient market structures for government securities markets. In the case of developing countries and economies in transition where financial markets are less-developed, an active role of the authorities in encouraging efficient market organization can be a powerful catalyst in the development of government securities markets. In turn, these markets help support debt management, monetary policy, and financial market reforms.

Peter Dattels, *The Microstructure of Government Securities Markets*, *in* IMF WORKING PAPER 36 (1995) (offering superb taxonomy of government securities market structure and their policy implications).

20. For example, the Cuban Constitution provides that the government directs the economy for socialist ends. CONSTITUCION DE LA REPUBLICA DE CUBA art. 16 (Cuba) (amended 1992) ("The State organizes, directs, and controls the national economy consistent with a plan which guarantees the country's programmed development in order to strengthen the socialist system, to satisfy the material and cultural needs of society and its citizens . . ."). Although economists usually criticize rent-seeking as resulting in an inefficient allocation of resources, in the case of a command economy with only a nascent private sector, such as, Cuba, one-off deals between officials and private constituencies—which may not be fully legalizable within the constraints of formal law—may contribute to economic arrangements with benefits to parties outside of the rent-seeking deal.

21. Geoffrey P. Miller, *An Interest-Group Theory of Central Bank Independence*, 27 J. LEGAL STUD. 433 (1998). Professor Miller is the Director of the Center for the Study of Central Banks at the New York University School of Law. He does not offer empirical examples of rent-seeking by the constituencies of a would-be central bank, due perhaps to the relative obscurity in which central banks operate—a fact berated by populist advocates of increased transparency. He does, however, identify the specific economic transaction—the deal between officials and finance firms—responsible for the emergence of independence. *Id.* at 452–53.

22. *Id.* at 434.

independent central bank represents a way for these politicians to extract rents from special interest groups by promising *ex ante* not to produce inflation.[23] In other words, by making a longer-term deal with special interest groups not to inflate the currency, the politician can actually extract more rents than if she makes an initial deal with the group, encourages inflation to disrupt the deal, and then extracts new rents in exchange for resolving the conflict in favor of her rent-seeking counterparty.[24] But:

> [T]he politician needs a mechanism for reliably precommitting not to engage in inflationary actions. The independent central bank is a relatively reliable (although not perfect) precommitment mechanism. Thus, self-interested politicians may favor independent central banks even though, in doing so, they relinquish the enormously important power of price-level control.[25]

To be more explicit, the rent-seeking deal between the official and the political or market constituency is an extralegal contract[26] with no formal enforcement mechanism but imbued with

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23. *Id.* at 435.

24. In the case of Cuba, such a long term deal might help to extend the term of Cuban government borrowing.

25. *Id.* at 453. Ulysses' intertemporal conflict with the Sirens often appears in the central banking literature as a metaphor for how formal independence acts as a precommitment mechanism. Consider this elegant passage:

> In modern economic terms, Ulysses faced a problem of time inconsistency in his optimal plan. His optimal plan was to listen to the Sirens and then continue on his journey. But this was time-inconsistent, because once he embarked on the plan of listening to the Sirens, he would not be able to implement and accomplish the later part of this plan— returning home. . . Ulysses then elaborated an "optimal plan" in which he came up with the idea of denying himself his legitimate right to decide the ship's course at some point in the future. He instructed his men to tie him up to the mast and ignore any orders to do anything other than sail away from the reefs after some pre-established, planned point. To assure total compliance from his crew, Ulysses told them to plug their ears and row.

Colares, *supra* note 10, at 158 (citations omitted).

26. This is an example of an argument based on the behavioral assumption about opportunism made by Williamson: *Ex ante*, self-interest induces the rent-seeking deal, and *ex post*, more of the same tempts the official to use discretionary powers for serial self gain. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS]. As for characterizing the degree of

all of the counterparty considerations typical of a legal bargain. This is not to suggest that dependent central banks refrain from rent-seeking. Quite the contrary, deals between officials and other constituencies may occur more frequently for the reasons that form the predicate of the central bank hypothesis. Independent governance does not determine the incidence of deal-making, but rather the governance structure of the deal. In other words, a viable pre-commitment mechanism lets the counterparties pursue their expectations over a longer time horizon.[27] What then does central bank independence in both developing and developed countries *really* signal? Central bank independence is a sign of good things (other than low inflation) to come, namely rents.[28]

One implication of this view is that modeling rent-seeking as a type of extralegal contract extends transaction costs analysis to public institutions—in this case to a quasi-public institution charged with conducting macroeconomic policy.[29] More gener-

self-interest involved as mild, moderate, or opportunistic, this Article asserts that converting a public institution—that is, the interest rate setting mechanism—for private gains is an opportunistic, rather than a mild degree of self-interest. Once officials have ceded discretion over money policy to an independent rate setting mechanism however, the mechanism blocks any *ex post* moves. See *infra* notes 31–35 for a wider consideration of the analytical value of opportunism as an institutional framework.

27. Increasing the term of foreign investor commitment could contribute to lengthening the term of loans sought by Cuban borrowers. See *infra* note 60 for a discussion on the lack of medium- and long-term credit for Cuban borrowers.

28. Rents which would interest an investor in a host country might include inside information from regulatory authorities, getting a hearing for investment concerns, or securing advantages through informal contacts with and in respect of the central bank.

29. This type of application of transaction cost economics to public finance was considered as early as 1985:

> An area to which transaction cost economics has made only limited contributions but that holds out considerable promise is public finance. . . But if the choice and design of institutions is what public finance is all about, then countless applications of transaction cost economics have yet to be made. Problems of incentives and governance are enormously difficult in a political context. Tolerance for greater variance in relation to private sector efficiency assessments is likely to be needed.

WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 26, at 394–95. Williamson also notes the value of comparative study with institutions in socialist countries: "[A]lbeit difficult to orchestrate, contacts between capitalist and socialist countries regarding the study of governance structures—with attention to both similarities and differences—hold considerable promise for deepening our understanding of those matters." *Id.* at ally, the impact of creditor interests on state formation through rent-seeking may be studied through transaction cost economics, which uses the transaction as the relevant unit of analysis. Transaction cost theory would suggest that the transaction must have a governance structure and that the costs associated with entering the transaction would determine whether the deal is executed.[30] These transaction costs are matters of public interest.

For example, assuming, as does this Article, that rent-seeking drives state formation more broadly, a rent expenditure budget of the deal implemented in any central bank's chartering legislation would be useful. Such an analysis would treat rents as notional outlays of budget resources. The analysis would identify the financial stakeholders in central bank design, consider competing deals between them and the government, and finally, analyze the allocative efficiency and distributional impact of the final deal enacted.[31] Sobering behavioral assumptions about individual and institutional action have enormous policy value when considering how private constituencies impact state structure. [32] Assuming a more robust form of self-interest explains much of daily economic life's ordinary depravity.[33] Such

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30. Oliver E. Williamson, *Public and Private Bureaucracies: A Transaction Cost Economics Perspective*, 15 J.L. ECON. & ORG. 306, 312. (1999). Williamson notes that one reason why transaction costs economics has not applied to state action is that scholars view the social and economic organization of the private and public sector differently. *See id.* at 308–10. Quantifying rents transactions, however, helps to create a common unit of account across both the public and private sectors.

31. Obviously, I am thinking about the tax expenditure budget concept developed by Stanley Surrey. *See* Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. IND. & COM. L. REV. 679, 679–81 (1976). Rents analysis would shed light not just on central bank formation but also on the central bank's recurring decision-making behavior, as the special interest which contributed to formation may continue to influence subsequent interest rate determinations.

32. Rent-seeking is an example of opportunism: "By opportunism I mean self-interest seeking with guile. This includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating. Opportunism more often involves subtle forms of deceit. Both active and passive forms and both ex ante and ex post types are included." WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 26, at 47. Bounded rationality is the other major behavioral assumption of transaction cost theory. *See id.* at 45.

33. This charming phrase appears in an argument about judicial power from The

an approach also spans law and economics, alterity narratives,[34] and other postmodern methodologies[35] which have historically maintained theoretical boundaries with respect to each other.[36]

Federalist Papers: "And making the proper deductions for the ordinary depravity of human nature, the number [fit for judicial office] must be still smaller of those who unite the requisite integrity with the requisite knowledge." THE FEDERALIST NO. 78 (Alexander Hamilton).

34. Postmodern study uses the word "alterity" to refer to the dynamics of otherness. "Postmodernism is obsessed with otherness." STEFAN HERBRECHTER, LAWRENCE DURRELL, POSTMODERNISM AND THE ETHICS OF ALTERITY 3 (1999). As a subjective position, alterity has been received in U.S. jurisprudence most directly through the development of the outsider jurisprudence movements mentioned by Rubin. Although much outsider jurisprudence critically evaluates U.S. institutions, this Article uses the phrase "alterity jurisprudence" in order to situate both this Article and outsider jurisprudence into a globalized postmodern discourse. *See also* Francisco Valdes, *Culture, "Kulturkamp," and Beyond: The Antidiscrimination Principle under the Jurisprudence of Backlash*, *in* THE BLACKWELL COMPANION TO LAW AND SOCIETY 276–79 (Austin Sarat ed., 2004). The behavioral assumptions listed by Williamson trace part of the subjectivity of a notional "other," detached from socialization into noneconomic concerns. *See* WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 26, at 44–52. In terms of increasing the allocative efficiency of the mind, this critical vantage point has enormous practical (and theoretical) implications for self-reflection and collective action, both individually and institutionally.

35. Edward Rubin, *The New Legal Process, the Synthesis of Discourse, and the Microanalysis of Institutions*, 109 HARV. L. REV. 1393, 1421 (1996). "Foucault does not ally himself with critical theory or any prescriptions for radical change. As Nancy Fraser suggests, however, this alliance is implicit in the entire work; his elusiveness is a matter of style, not substance." *Id.* Foucault modeled power as a pervasive, ambient force—like social gravity, if you will—independent of and prior to institutional arrangements, but animating their nature. *See* MICHEL FOUCAULT, DISCIPLINE AND PUNISH THE BIRTH OF THE PRISON 26–27 (1991). Insisting on accounting for human activity through rent-seeking analysis may help to show how the power field described by Foucault would manifest itself at the cellular level of a person's actions and her influence over an institution.

36. *See* Rubin, *supra* note 35, at 1420–21. Rubin notes that the critical approaches of law and economics and alterity jurisprudence have been essentially dichotomized in the academic short-run due to the accident of history:

> An obvious explanation is the divergent political predilections that gave rise to each movement, but the correspondence between the political positions and their methodologies is not logically required. That is, economic analysis is not necessarily the exclusive instrument of the political right, nor deconstruction the instrument of the left; political debate could have been carried out within either methodological framework.

Id. at 1401–02. Rubin continues:

> In fact, it is remarkable how disconnected the two movements are, given that they have developed in the same academic institutions, published in the

In the spirit of synthesizing critical and economic discourses, this Article proposes a financing vehicle to remedy the signaling issues raised by the Central Bank's governance structure.[37] The importance of signaling to attract foreign financing becomes clearer after appreciating the credit scarcity and illiquidity which characterize Cuba's dire foreign financing position, and will be described in the following Part.

C. *The Implications of the Rent-Seeking Theory to the Central Bank*

Rent-seeking theory also supports the emergence of a dependent central bank in a political economy without robust rent-seeking by finance firms with interest rate preferences. By counter-implication of the thesis that central bank independence serves as a pre-commitment mechanism for bargained-for rents, the Central Bank is unlikely to gain independence without the emergence of a nongovernmental creditor class with enough political clout to lobby its interest rate preferences. The Cuban banking sector reforms of the 1990s have resulted in an institutionally differentiated market structure, although centralization of government discretion reduces the viability of any single banking institution as a pre-commitment mechanism.[38] Although foreign banks may open representative offices on the island, the government conducts all domestic banking. As a result, Cuba does not have a robust private financial sector ready to seek rents from the government through private deals.[39]

> same scholarly journals, and shared a common concern with law and legal institutions . . . Because any synthesis of these movements is likely to occur at the level of scholarly discourse, and not at the level of substantive political positions, real possibilities for synthesis emerge primarily in this methodological realm.

Id. at 1412.

37. Making recommendations that are capable of being implemented is part of the institutional microanalytic approach. Rubin notes, "[t]he microanalysis of existing institutions is more practical, at least in the short run, and more amenable to the specifically legal approach of framing recommendations to existing policymakers." *Id.* at 1432. Both the the rent expenditure budget and the collateralized debt proposed in Part IV are examples of such recommendations.

38. *See* CUBA AT A CROSSROADS, *supra* note 12, at 252–54.

39. *Id.* at 244–49.

Therefore, Cuban officials may restructure the banking sector with relatively little resistance from external creditor interests. A dependent central bank does not necessarily signal to foreign investors that inflation is on the way. Actually, it has unfortunately been a fact of life in Cuba for some time. Instead, it signals that long-term rent-seeking is not one of the rules of the game.[40]

Recommending government action to increase formal independence by amending the Decree-Law creating the Central Bank[41] is futile. A private rent-seeking economy must grow before the financial sector can shape central bank design to serve the term interests of the sector's balance sheet. For these reasons, the Central Bank will become independent not due to political reform—even that urged by U.S. democracy activists—but only after the entrenchment of a private creditor class capable of pressing demands on government officials.

Since the Decree-Law does not create an independent institution,[42] and since more independence is unlikely in the future, what may the Central Bank do now to improve the island's foreign financing position, including securing a longer term for foreign investment? Affirming the importance of more access to foreign financing for Cuba, Part IV recommends a proposal to use collateralized government debt to extend the term of official borrowing and to signal openness to commercial expectations. The relevance of this proposal becomes more obvious after understanding the credit scarcity and monetary confusion which characterize the current Cuban economy, discussed in the following Part.

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40. Although Charles Beard noted gaps in documentation of the economic interests of the framers, he reviewed enough records to survey the economic interests at work in the Constitutional Convention. *See* CHARLES A. BEARD, AN ECONOMIC INTERPRETATION OF THE CONSTITUTION OF THE UNITED STATES 34–40 (MacMillan 1929) (1913). Less documentary evidence about the Central Bank is available with which to survey the economic interests that contributed to the adoption and structure of the Decree-Law.

41. *See infra* note 100 and accompanying text (discussing Decree Laws).

42. DECRETO-LEY 172 (1997) (Cuba).

II. CUBA'S FOREIGN FINANCING POSITION

Cuba's foreign financing position is composed primarily of limited foreign direct investment and debt obligations. Although Cuba repaid its obligations to the International Monetary Fund (IMF) after withdrawing from the organization in 1964,[43] Cuba currently faces a debt sustainability problem and limited access to other forms of foreign financing. The current foreign financing position developed largely from the loss of favorable terms of trade with the former Soviet Union and its trading partners.[44]

A. Foreign Direct Investment

In response to the loss of Soviet financing, Cuba has liberalized its foreign investment market to attract foreign capital inflows. During the 1990s Cuba enacted several laws, including a new foreign investment law, designed to recoup financing losses caused by the loss of favorable terms of trade with the Soviet Union and other Counsel for Mutual Economic Assistance (CMEA) members.[45] To improve its contractual credibility with

43. *See* JAMES M. BOUGHTON, SILENT REVOLUTION THE INTERNATIONAL MONETARY FUND, 1979–1989, at 758 (2001).

44. Marquetti Nodarse Interview, Institute for the Study of the Cuban Economy, University of La Habana, in Havana, Cuba (Dec. 22–24, 2003) [hereinafter Marquetti Nodarse Interview]. An investigator at the University of Havana's Institute for the Study of the Cuban Economy, Dr. Marquetti Nodarse is one of the foremost authorities on the Cuban economy, particularly in domestic and international monetary issues. Exports provide the exporting country with foreign exchange liquidity for, among other things, payment of foreign currency external debt. *Id.* Between 1972 and 1986, Cuba's main export (and import) markets were the members of the Counsel for Mutual Economic Assistance (CMEA). *Id.* The CMEA was an autarchic trading block made up of the USSR, Hungary, Czechoslovakia, Poland, Romania, Bulgaria, East Germany, Mongolia, Vietnam, and Cuba. Cynthia B. Schultz & Tamara Raye Crockett, *Economic Development, Democratization, and Environmental Protection*, 18 B.C. ENVTL. AFF. L. REV. 53, 55 n.9 (1990). The terms of trade with CMEA partners resulted in a financing subsidy to Cuba, where Cuba exported sugar and nickel at a premium and imported oil at a discount. *See* Marquetti Nodarse Interview, *supra*. The spread between these trades subsidized the Cuban economy. *Id.* When the CMEA dissolved in 1985, Cuba lost this funding spread. *Id.* By 1992, Cuba's volume of international trading had dropped to 1974 levels. *Id.*

45. In 1996, Cuba passed the Reaffirmation of Cuban Dignity and Sovereignty Act, Law No. 89, GACETA OFICIAL, Dec. 24, 1996, directing government agencies to use fiduciary agencies and other conduits to protect the identity of foreign investors exposed to legal risk from the Cuban Liberty and Democratic Solidarity (Helms-Burton) Act of

potential investment partners, Cuba also signed numerous bilateral investment treaties with other countries to limit the exposure of their respective nationals to Cuba-sourced political risk.[46] Although the 1995 law improves the investment climate over the climate produced by the prior foreign investment law,[47] the legal framework for regulation has failed to optimize the volume of foreign investment due to prospective investors' perceived investment obstacles.[48] At the same time, the United States has successfully injected U.S.-sourced political risk into Cuban foreign investment subject to the Helms-Burton Act.[49] As a result, efforts to attract foreign equity investment have not yet attracted enough foreign capital to meet Cuba's financing needs.[50] After scant academic interest in Cuban law, Cuba's

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1996, 22 U.S.C. §§ 6021–6091 (1996). In 1997, Cuba passed a foreign investment law to facilitate foreign direct investment. *See* Foreign Investment Law, Law No. 77, GACETA OFICIAL (1995). In 1999, Cuba provided that Cubans who assist in the implementation of the Helms-Burton Act against foreign investors in Cuba may be punished by up to twenty years imprisonment. *See* Law for the Protection of National Independence and the Cuban Economy, Law No. 88, GACETA OFICIAL (1999). Cuba also took steps before enacting Law No. 77 to stimulate investment. *See* Jorge F. Pérez-López, *Cuba's Thrust to Attract Foreign Investment: A Special Labor Regime for Joint Ventures in International Tourism*, 24 U. MIAMI INTER-AM. L. REV. 221, 222–23 (1992) [hereinafter Pérez-López, *Cuba's Thrust*]. Pérez-López is an eminent authority on Cuban macro- and micro-economic issues.

46. *See* Jorge F. Pérez-López & Matis F. Travieso-Diaz, *The Contribution of BITs to Cuba's Foreign Investment Program*, 32 LAW & POL'Y INT'L BUS. 529, 540 (2001).

47. *See* Venera A. Gallousis, *Cuba's Flirtatious Love Affair With Foreign Investment: The Evolution of Laws 50 and 77*, 5 TEX. HISP. J.L. & POL'Y 81, 82–83 (2001).

48. *See* Matias F. Travieso-Diaz & Charles P. Trumbull IV, *Foreign Investment in Cuba: Prospects and Perils,* 35 GEO. WASH. INT'L L. REV. 903 (2004), at 903–04.

49. *See generally* Jorge Pérez-López, *Foreign Investment in Cuba in the Second Half of the 1990s* (Apr. 30, 2000) [hereinafter Pérez-López, *Foreign Investment in Cuba*] (unpublished article, on file with author). *See supra* note 45 (discussing the Helms-Burton Act). Investors during this period came from Brazil, Canada, China, Chile, Dominican Republic, France, Germany, Honduras, Israel, Italy, Jamaica, Japan, Mexico, The Netherlands, Panama, Portugal, Russian Federation, South Africa, Spain, Sweden, United Kingdom, Uruguay, and Venezuela. U.S.-Cuba Trade and Econ. Council, Inc., *Foreign Investment and Cuba*, *at* http://www.cubatrade.org (last visited Apr. 10, 2005). Since 1990, foreign firms have committed or delivered only about $1.65 billion in capital in Cuba, although these firms had originally announced investment of more than $6 billion. *See id.*

50. Foreign investment also exposes Cuba to forward foreign exchange payables. Foreign investors fund their investments with foreign exchange—not Cuban currencies—thereby providing foreign exchange liquidity. Conversely, these investors want

modest liberalization reforms have produced a proportionate increase in Cuba-related legal scholarship, illustrating how in the U.S. scholarship market modes of economic production interact with knowledge production.[51] Regretfully, recent changes in U.S. policy have reduced the flows of both financial and intellectual capital between Cuba and the United States.[52]

their investment return funded in a stable currency, creating foreign exchange payables for Cuba.

51. Many law review articles discuss the implications of Law No. 77, Cuba's most recent foreign investment law. *See* John J. Coughlin, *Cuban Foreign Investment Act: Opportunities for United States Corporations in a Post-Embargo Era,* 23 SUFFOLK TRANSNAT'L L. REV. 299 (1999); *see also* Francisco J. Viñas, *Establishing and Protecting United States Foreign Investment in a Post Castro Cuba: By Waiting for Castro, Will U.S. Investors Miss the Boat?*, 5 J. TRANSNAT'L L. & POL'Y 227 (1996); Ron First, *Cuba's Changing Foreign Investment Climate: Castro's Attempt to Lure Foreign Investors*, 9 TRANSNAT'L LAW. 295 (1996); Travieso-Diaz & Trumball IV, *supra* note 48; Pérez-López, *Foreign Investment in Cuba*, *supra* note 49. Other articles compare Law No. 77 with Cuba's earlier attempt to attract foreign investment. *See* Gallousis, *supra* note 47, at 83. Others discuss Cuba's foreign investment climate before the enactment of Law No. 77. *See* Pérez-López, *Cuba's Thrust*, *supra* note 45.

52. Any mention of Cuban legal studies necessarily involves consideration of U.S. federal constraints on academic freedom. *See* 31 C.F.R. § 515.565 (2005). In June 2004, amendments to the Cuban Assets Control regulations radically curtailed the ability of U.S. academics and educational institutions to conduct educational activities with Cuban academic counterparties. *See* Correspondence Between Officers, Latin American Studies Association (on file with author). For example, the amendments shortened the term of the special academic license from two years to one year and required that all educational programs in Cuba operated by U.S. educational institutions last at least ten weeks. *Id.* Before the June measures, twenty-five U.S. universities operated educational programs; now only three U.S. educational institutions maintain programs. *Id.* On November 19, 2004, the Academic Freedom Focus Group of the Cuban Academic Alliance met in Washington with representatives from forty-nine universities and educational exchange groups to consider constitutional challenges to the June measures based on the First and Fifth Amendments. *See* Academic Freedom Focus Group at the Cuban Academic Alliance Conference Materials (on file with author). Astonishingly, the U.S. State Department denied visas to each of the sixty-one Cuban academics and professionals who had been invited to participate in the October 2004 meeting of the Latin American Studies Association, whose academic conferences have included a Cuban delegation since 1977. *See* Syke Stephenson, *Policy Winds and Exchange Flows: Forty Years of US-Cuban Academic and Educational Exchanges* (presented at the 2004 meeting of the Latin American Studies Association, publication forthcoming) (on file with the author). The U.S. government's reason for curbing remittances from U.S. residents to the island is a fundamental part of the U.S. government's policy behind the Cuban embargo: to impair the Cuban government's ability to perform so as to create popular dissatisfaction which will ultimately lead to the demise of the Castro government, by peaceful or violent means. 22 U.S.C. §§ 6001, 6032(a) (2000). The wisdom of curbing re-

B. Cuban Credit Market

The country's official debt now consists mostly of official multilateral and bilateral financing, some private credit from foreign banks, and short-term trade finance for exports and imports.[53] Cuba's foreign credit market has been insulated from the market structure shift in emerging market debt from bank loan financing to securities financing catalyzed by the U.S. Brady Plan.[54] Securities financing requires a nuanced debt management approach to dealing with a group of diverse (and anonymous) bondholders with different liquidity and transaction cost preferences—for example, a preference to bring suit as a hold-out creditor rather than to join a restructuring agreed to by other creditors. As a result, Cuban credit suffers not only from a sub-investment credit rating but also from an outmoded debt issuance approach. [55]

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mittances to create popular dissatisfaction is impeccable. The recent curbs have in fact lowered the standard of living of large numbers of Cubans who formerly derived marginal value from the dollar remittances. However, the related premise that this popular deprivation will lead to a change in government has yet to be demonstrated *ex post*. Even *ex ante* this premise seems inconsistent with the conclusion—foundational to U.S. policy on Cuba—that the Castro government operates a totalitarian police state which could effectively repress any sedition or insurrection. In the case of Cuba, it obviously takes more than a tax on tea (or withholding tea at all for that matter) to spark another revolution.

53. *See* Hiram Marquetti Nodarse, *La Deuda Externa de Cuba en los Años Novent: Evolución y Perspectivas* [*Cuba's Foreign Debt in the 1990s: Evolution and Perspectives*], CENTRO DE ESTUDIOS DE LA ECONOMÍA CUBANA [hereinafter Marquetti Nodarse, *Cuba's Foreign Debt*].

54. *See* Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Further Restructurings*, 64 FORDHAM L. REV. 2701, 2719-20 (1996) (describing how "[i]n March of 1989, then U.S. Secretary of the Treasury Nicholas Brady . . . announced a new initiative designed to encourage banks voluntarily to reduce the debt burdens of LDC debtors."). The Brady Plan ushered in a shift from bank syndicate financing to capital market deals by securitizing whole bank loans into a new asset class: emerging markets securities. *Id.* At first Brady bonds, which converted loan obligations into bonds, were collateralized only with a special non-marketable zero-coupon long-term bond, specially issued by the U.S. Treasury pursuant to its borrowing authority under 31 U.S.C §§ 3102, 3121. *Id.* at 2721.

55. The policing and contract enforcement costs of recovering on sovereign debt are an example of a transaction cost. *See* Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979). One benefit of the collateralized debt proposal discussed in Part IV is that the debt flotation would expose Cuban government officials to current financing practices applying the mechanism described above for Brady securitized

Predictably, Cuba's debt rating has a sub-investment rating of Caa 1.[56] A sub-investment debt rating also increases the cost of equity financing.[57] *Moody's*[58] reports that recent credit trends include rising short-term debt, payment delinquencies, and deteriorating credit and collateral terms.[59] *Moody's* also reports that Cuba requires many non-U.S. trade creditors to roll over short-term debt into longer term loans and to reschedule principal and interest payments.[60] A leading Cuban economist argues that the availability of only short-term credit is one of the Cuban credit market's most severe problems.[61] Nevertheless, with minor exceptions, Cuba's foreign debt has risen steadily.[62] In the

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debt.

56. Annual reports on the Cuban credit market are regularly issued by *Moody's Investors Services*. *See generally Moody's Investors Service Global Credit Research Reports for Cuba, June 2001 to July 2003* [hereinafter *Moody's Reports for Cuba*] (on file with author).

57. Part of equity's value depends on the liquidity and solvency—essentially the creditworthiness—of the underlying business. In this sense, equity investors are also creditors of a firm. When interest rates rise, the cost of repaying fixed-rate debt drops, and thus, the value of the debt drops, relieving the debtor and annoying the creditor. *See* Douglas W. Elmendorf & N. Gregory Mankiw, *Government Debt*, *in* HANDBOOK OF MACROECONOMICS (John B. Taylor & Michael Woodford eds., 1999).

58. *See supra* note 56.

59. *See Moody's Reports for Cuba*, *supra* note 56.

60. *Id.* By continuing to extend credit to Cuban borrowers in this situation, repeat lenders may be implicitly recognizing that the stated credit maturities are shorter than the terms that these lenders are willing to bear. U.S. based companies that export agricultural products to Cuba, however, assume no risk of involuntary credit extension because these businesses may trade only on cash or non-U.S. origin credit (so that a non-U.S. entity bears the trade credit risk). *See* Trade Sanctions Reform and Export Enhancement Act of 2000, 22 U.S.C. § 7207 (2000). Allowing for credit financing of U.S. exports would mean that exporters would have to compete among themselves with respect to credit terms. Predictably, U.S. exporters have objected to amending the Act to allow for credit financing. *See* U.S.-Cuba Trade and Econ. Council, Inc., *Economic Eye on Cuba*, Jan. 20–26, 2003, at 2 (results of survey of 307 U.S. based companies with export interests in Cuba), *available at* http://www.cubatrade.org/eyeon2003/20Jan03.pdf (last visited Apr. 10, 2005). Exposing agricultural exporters to Cuba to compete on market terms with each other with respect to trade financing—as they do in export markets generally—is entirely in line with this Article's recommendations.

61. *See* Marquetti Nodarse, *Cuba's Foreign Debt*, *supra* note 53.

62. *Id.* (noting for the period 1989 to 2001 an increase in gross debt from $6.1652 billion (U.S.) to $10.893 billion (U.S.)). Marquetti Nordarse's data comes from the Cuban Central Bank and its predecessor from 1948 to 1997, the National Bank of Cuba. *Id.* This figure does not include a convertible ruble debt of $21 billion originally contracted

context of its per capita debt, national product, and export capacity, Cuba has a debt sustainability problem reflected in its sub-investment grade credit rating of Caa1[63] and repayment history.[64] The paucity of granular data on Cuban external debt makes analysis of credit trends difficult, but the conclusion of debt unsustainability rests both on current and anticipated illiquidity. Due to its prior expropriations and limited transactional experience in global trading markets—limited due to Cuba's prior reliance on the Council for Mutual Economic Assistance (CMEA)[65] and to long standing United States restrictions on market participation[66]—Cuba faces a fundamental contractual credibility deficit, reflected most obviously in its credit rating. No private debt market is likely to develop without a government securities market.[67] Noting the official position in favor of selec-

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with the Soviet Union but repudiated by Cuba after the break-up of the Soviet Union. Data on Cuban foreign debt is available from several sources. *See, e.g.*, Bank for Int'l Settlements, *Joint BIS-IMF-OECD-World Bank Statistics on External Debt*, *at* http://www.bis.org/publ/r_debt.htm (statistics compiled in a joint effort of the Bank of International Settlements, IMF, the Organization for Economic Cooperation and Development, and the World Bank) (last visited Apr. 10, 2005). The foreign debt statistics released by these multilaterals report less than one-tenth of Cuba's official reported bilateral debt perhaps because the multilateral data comes from reporting creditors who may underreport credit exposure to Cuba because of the attendant legal risks from United States law. Marquetti Nodarse's data comes from Cuban authorities (for which admissions of liabilities are a declaration against interest). On the basis of these interpretive assumptions, this Article relies on Marquetti Nodarse's foreign debt data because it is more comprehensive than that of other sources. This data evaluation problem is typical of Cuban area studies.

63. *See Moody's Reports for Cuba*, *supra* note 56.

64. *See* CUBA AT A CROSSROADS, *supra* note 12, at 247. Since Pérez-López' 1994 analysis, Cuba's external debt appears to have nearly doubled. *See* Archibald R. M. Ritter, Cuba's Economic Performance and the Challenges Ahead, FOCAL, at 10 (demonstrating general increase in Cuba's external debt from 1994–2001).

65. Christopher A. Brook, Comment, *Cuba: Undermining or Underlining the "Race to the Bottom?"*, 30 N.C. J. INT'L L. & COM. REG. 197, 241 & n.345 (2004).

66. *See* 22 U.S.C. §§ 7201–7211 (2000).

67. In emerging capital markets, government securities are often the lead fixed-income security in terms of reform. Debt managers often attempt to construct a yield curve or to lengthen the term of debt with government securities, in part because it tends to be the most liquid fixed income sector. As in the United States, the government's borrowing rate is often the reference rate for private debt, as well. The Federal Reserve Board, OPEN MARKET OPERATIONS 35–42, THE FEDERAL RESERVE SYSTEM PURPOSES, *at* http://www.federalreserve.gov.pf.pf.htm (last visited Apr. 10, 2005).

tive market liberalization adopted at the Fourth Congress of the Communist Party in 1991,[68] it has been argued that the Cuban government has approached its major official creditors, informally, to signal increased transparency by releasing additional information about the economy.[69] These modest steps may signal increased willingness to transact in the global credit market on commercial terms fundamentally different from previous Cuban postures, although, as discussed above, substantially more liberalization has taken place in the area of foreign direct investment than in the credit market.

Currently, investors lack enough information about Cuba's creditworthiness to make investment decisions, especially regarding uncollateralized investments.[70] Cuban debt is compro-

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68. Breaking with the Cuban Communist Party's historic opposition to foreign investment, the Fourth Party Congress recognized the need for increased foreign investment in market-friendly terms:

> As a complement to the investment efforts the country must make, foreign investment is being stimulated in branches and territories where it is warranted, due to its contribution of capital, technology, and markets, utilizing different forms of partnership for this end, such as joint ventures, cooperative production, marketing agreements, shares, and others, according to the regulations established by our legislation.

Resolution on the Country's Economic Development, *in* GAIL REED, ISLAND IN THE STORM, THE CUBAN COMMUNIST PARTY'S FOURTH CONGRESS 132–35 (1992) (noting Cuba's willingness "to develop additional investment projects, giving preferential treatment to [Cuba's] partners in Latin America and the Caribbean"). As a result of this economic liberalization policy as well as other reforms approved by the Fourth Party Congress, the Cuban Constitution was amended in 1992. *See* Peréz Milán, *Motivos Para Una Reforma*, 7 REVISTA 3, 4–6 CUBANA DE DERECHO (1992).

69. *See* Marquetti Nodarse, *Cuba's Foreign Debt*, *supra* note 53.

70. *See* Archibald R. M. Ritter, Unifying Cuba's Dual Monetary and Exchange Rate Systems 17 (2003) [hereinafter Ritter, Unifying Cuba] (unpublished manuscript, on file with the Carleton University Library).

> The dual monetary system currently in force in Cuba also makes an accurate analysis of the Cuban monetary system and indeed the Cuban economy in general difficult and maybe impossible. The dual currency and double exchange rate complications are not treated transparently in information presented publicly on inflation, the value of the money supply, the government budgets, and the national accounts.

Id. This lack of information hinders Cuban area studies as well. Addressing the situation of the island's economic professionals, Ritter notes that "[f]orcing Cuban analysts to work without good basic information obstructs their endeavors to contribute to an understanding of the economy and wastes their talents and energies." Archibald R. M.

mised by political risk from U.S. and multilateral sanctions, historic expropriation risk, and the liquidity risk from unresolved private and public law claims based on prior expropriations and Cuba's offsetting claims for embargo losses.[71] Any purchaser of Cuban debt would, therefore, demand a significant risk premium for holding uncollateralized sub-investment grade Cuban debt. So, Cuban debt would have to be secured with enough liquid collateral to make an investor indifferent between a Cuban instrument and a less risky security. Liquid collateral is the ultimate financial "hostage" that a counterparty may hold as security for a contractual commitment.[72] Expropriation-proof collateral would make an investor indifferent to the legal risks of investing in a country with limited private contract and property rights.

Although U.S. law generally limits financial transactions related to Cuba,[73] the Johnson Debt Default Act (Johnson Act) additionally restricts the issuance of Cuban debt in the U.S. capital market, hence limiting the Central Bank's ability to act as a fiscal agent for the government's official borrowings.[74] Specifically,

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Ritter, *The Dual Currency Bifurcation of Cuba's Economy in the 1990s: Causes, Consequences and Cures*, 57 CEPAL REV. 113, 114 (1995) [hereinafter Ritter, *Dual Currency*]. The same point may be made about public access to scholarly information about Cuban law, which is dramatically underpublished. For example, Cuba has only one major scholarly legal journal, REVISTA CUBANA DE DERECHO.

71. Investors with different preferences about risk (including credit, liquidity, and legal risks, such as fear of prosecution for violating capital control sanctions) and transaction costs will value this bundle of Cuban contingencies differently of course. Regarding risk, some investors may be willing to pay a "first-entry" premium for the early chance to invest in Cuban assets, especially if these investors can make a meaningful, simplifying assumption about trends in the Cuban economic climate. With respect to transaction cost preferences, for example, some investors with successful relationships with Cuban officials and institutions may be able to economize on information costs or contract performance costs of investments in Cuba.

72. The commitments of contractual counterparties who offer "hostages" are more credible. *See* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 120–44 (1996).

73. 22 U.S.C. § 6021 (1996); 31 C.F.R. § 515.201 (2002).

74. The Johnson Debt Default Act, 18 U.S.C. § 955 (2000) [hereinafter Johnson Act], prohibits credit access in the United States for certain countries in default of their obligations to the United States. The Johnson Act provides:

> Whoever, within the United States, purchases or sells the bonds, securities, or other obligations of any foreign government or political subdivision thereof or any organization or association acting for or on behalf of a foreign

the Johnson Act prohibits the purchase or sale within the United States of the securities or obligations of any sovereign who is in default of obligations to the United States and does not belong to both the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). The Johnson Act was amended in 1994 to apply only to countries that do not belong to the IMF or the IBRD.[75] Cuba belongs to neither.[76]

Part III of this Article will further propose a collateral arrangement that could make foreign investors indifferent to Cuba's historic credibility deficit, hence increasing the country's access to foreign debt financing. Improved credit standing from an isolated transaction would not directly enhance foreign investment as much as an upgrade of Cuba's country credit rating because it is the country credit rating that impacts the terms of foreign investment (since foreign direct investors bear country credit risk through their investment). However, enhancing the country's creditworthiness, even with respect to discrete transactions, would improve the foreign investment climate by contributing to a culture organized around commercial expectations.

> government or political subdivision thereof, issued after April 13, 1934, or makes any loan to such foreign government, political subdivision, organization or association, except a renewal or adjustment of existing indebtedness, while such government, political subdivision, organization or association, is in default in the payment of its obligations, or any part thereof, to the United States, shall be fined under this title or imprisoned for not more than five years, or both.

18 U.S.C. § 955. The sole defaulted U.S. obligation that triggers the Johnson Act against Cuba is a non-concessional credit of $32,267,000 issued by the U.S. Export-Import Bank. *See 2002 U.S. Government Foreign Credit Exposure* report (known as the *Salmon report* for the color of the report's cover) prepared as requested by Conference Report on the Foreign Operations, Export Financing, and Related Programs Appropriations Act of 1990, Pub. L. 101–167, 103 Stat. 1195.

75. 18 U.S.C. § 955.

76. Both the IMF and the IBRD have a membership of 184 countries, while Cuba is a member of neither. *See* INTERNATIONAL MONETARY FUND, *at* http://www.imf.org (last visited Apr. 10, 2005)(noting the IMF membership number in *About Us*, and that Cuba is not listed in *Country Info*); THE WORLD BANK GROUP, *at* http://www.worldbank.org (last visited Apr. 10, 2005) (noting IBRD member countries in *About Us/Organization/Member Countries/IBRD Members*).

C. Monetary Disincentives to Increased Foreign Investment

Since the decriminalization of the dollar in 1993, the peso, the convertible peso, and foreign exchange each serve competing money functions in a fragmented economy with both formal and informal sectors. This currency balkanization has reduced foreign financing because without uniform money potential investors cannot evaluate the country's economic condition since no single currency represents the national liquidity, consumption, or production profile accurately. After a steady increase in dollarization, the Central Bank has very recently reversed this trend by using its fiat powers to bolster the convertible peso.

1. Dollarization

The peso has been Cuba's official money since 1914.[77] In 1993, the Cuban government decriminalized the holding of U.S. dollars, outlawed since about 1960 although widely used as illegal money.[78] Legalizing the dollar greatly increased the use of the dollar, so much so that until very recently the Cuban economy had become significantly dollarized.[79] The most prominent foreign observer of Cuba's monetary policies suggested that, in fact, the dollar may have been a more significant component of the Cuban money supply than the peso, although determining the actual supply of dollars in Cuba is impossible.[80] Since de-

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77. Cuba's first monetary law in 1914 established that both the Cuban peso and the U.S. dollar were national currencies. For a brief review of Cuba's banking history from the 18th century through the 1980s, see Raul M. Shelton, *The Historical Development of the Cuban Banking System: Lessons for the Future, Cuba In Transition 1*, *in* 4 CUBA IN TRANSITION: PROCEEDINGS OF THE ANNUAL MEETINGS OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY (Aug. 1994) (held at Florida International University, Miami, Fla., Aug. 11-13, 1994), *at* http://lanic.utexas.edu/la/cb/cuba/asce/cuba4/ shelton.html.

78. *See* DECRETO-LEY 140, GACETA OFICIAL (1993) (Cuba). Ritter notes that dollars circulated illegally until 1993. *See* Ritter, Unifying Cuba, *supra* note 70, at 4 (analyzing the currency structure of consumption and production in Cuba and policy implications of selecting among competing currencies).

79. *See Cuba: Reformas Estructurales en los Años Noventa. Resultados, Problemas y Perspectivas* [Cuba: Structural Reforms in the 1990s. Results, Issues, and Perspectives], *in* CENTRO DE ESTUDIOS DE LA ECONOMIA CUBANA 62 (citing JUAN TRIANA CORDOVÍ, LA ECONOMÍA CUBANA EN EL AÑO 2000 (CEEC 2001)).

80. *See* Ritter, Unifying Cuba, *supra* note 70, at 1, 10.

criminalization of the dollar in 1993, Cuban monetary policy has faced two choices in recent years: endorse some version of the peso or increase dollarization. To the extent that any single currency could be established as the dominant national currency, either option would have potentially improved the Cuban government's signaling capabilities by creating an intelligible medium—a single currency—through which foreign investors could analyze potential foreign investments. Only a Cuban national, of course, would preserve Cuba's national sovereignty over monetary policy.

Aimed at drawing money functions away from the burgeoning dollar and toward a domestic currency, Cuba then introduced the convertible peso, legally the equivalent of a synthetic dollar.[81] However, the government could not legislate the holding preferences of consumers as demand for the convertible peso never matched demand for the dollar. Cuba also legalized the use of the Euro in 2002, mostly in connection with the tourist flows from European Union member states.[82] As a result, the island developed a balkanized monetary system consisting of a socialist peso-based economy, a marketized dollar economy, and—to a much lesser extent—a Euro-economy. The system included official and informal exchange linkages between the different currency blocks,[83] but no single money that functioned both officially and informally.[84] In the short run, balkanization

81. Marquetti Nodarse Interview, *supra* note 44. The convertible peso must be backed by foreign exchange. Banco Central de Cuba Resolution No. 80/2004 (Oct. 23, 2004). The purpose of the convertible peso was to capture seignorage (the revenue earned by the sovereign from printing money) and to reduce demand for the U.S. dollar.

82. Banco Central de Cuba Resolution No. 80/2004 (Oct. 23, 2004).

83. Until recently, the Cuban government maintained an official exchange rate of one U.S. dollar to one Cuban (nonconvertible) peso in the peso economy. *See* Ritter, Unifying Cuba, *supra* note 70, at 32. Between 1991 and 2002, the informal exchange rate, that is, the black market rate, ranged from average peso/dollar rates of 20:1 to 90:1. *Id.* Most recently the peso/dollar rate has been at about 25:1.

84. Ritter describes the relationship between the two economies as of the mid 1990s thus:

> The [peso sector] was in a state of deep depression, organizational collapse, loss of confidence and general retreat. In contrast, the internationalized dollar-based part of the economy was expanding rapidly despite the recession, due to the increasing role of tourism and foreign investment, some public policy changes, and the vacuum left by the contraction of the tradi-

had a harrowing impact on the distributional goals of socialism.[85]

2. *Dedollarization*

Dollarization involves many costs to the Central Bank.[86]

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tional peso-based economy.

See Ritter, *Dual Currency*, *supra* note 70, at 115. Ritter notes the "underlying economic logic" of the shift away from the socialist economy and toward the dollar economy, but he points out a cruel irony:

> Indeed, the irony of the situation is that those who have been among the strongest supporters and beneficiaries of the Revolutionary regime in the traditional socialist economy (soldiers, workers, educational and health professionals) have been suffering material deprivation, whereas Cubans who have maintained good relationships with family members abroad, small-scale entrepreneurs and hustlers of various sorts receive substantially higher incomes, either in dollars or through better-rewarded self-employment.

Id. at 120.

85. Until recently, most Cubans depended for their basic foodstuffs on the government ration book (*la libreta*) that sets prices for these goods at 1960–62 levels. *Id.* at 116. Oxfam America concluded that that ration book does not satisfy minimum nutritional requirements for the ration period. *See* MIREN URIARTE, CUBA SOCIAL POLICY AT THE CROSSROADS: MAINTAINING PRIORITIES, TRANSFORMING PRACTICE 15, (2002), *available at* http://www.oxfamamerica.org/pdfs/social_policy.pdf. Persons with dollars or convertible pesos may supplement the ration book with other basic foodstuffs purchased at dollar stores, but only sixty-two percent of the Cuban population had access to any dollars at all. Archibald R. M. Ritter & Nicholas Rowe, *Cuba: From "Dollarization" to "Euroization" or "Peso Reconsolidation"?*, 107 LATIN AM. POL. & SOC'Y 99, 107 (2002). Because this statistic includes anyone with access to even a few dollars, the percentage of those with meaningful access is much lower. Marquetti Nodarse Interview, *supra* note 44. Persons dependent only on peso-funded government salaries or pensions earn between five dollars to twenty-three dollars a month. *See* Ritter, Unifying Cuba, *supra* note 70, at 14. The average wages of government doctors, teachers, and engineers for 2000 was between 200–450 pesos a month. *Id.* Assuming an unofficial exchange rate of twenty pesos to the dollar, those salaries translate to monthly income between ten dollars and twenty-two dollars and fifty cents. *Id.* Balkanization also threatened the island's ability to maintain current gains in human capital formation in the long run, as more people opted out of professional employment in the peso sector and pursued, instead, relatively unskilled jobs such as tourism services and sex work in the dollar sector. *See generally* Ritter & Rowe, *supra* (discussing the consequences of dollarization on the Cuban Economy and the shift away from the socialist to a marketized economy).

86. The Central Bank is decidedly not following the path of El Salvador, Ecuador, Nicaragua, and Panama toward dollarization. *See* Tyler Maroney, *Backgrounder: Dollarization*, INITIATIVE FOR POLICY DIALOGUE, *at* http://www2.gsb.columbia.edu/ipd/j_dollarization_bk.html (last visited Apr. 10, 2005); James W. Dean, *De Facto Dol-*

Further dollarization would transfer Cuba's monetary sovereignty to U.S. monetary authorities, whose rate setting policies would then determine the island's interest rates, rendering Cuba's monetary apparatus irrelevant. [87] Also, extracting rents by imposing capital controls in a dollarized system would be harder for officials, a rent-seeking factor that militates against the adoption by Cuban officials of further dollarization. Additionally, Cuba would sacrifice all seignorage (the money earned by the sovereign from issuing currency) generated from the issuance of pesos and convertible pesos, and would also sacrifice the arbitrage profits[88] that the government could earn by collecting dollars for goods produced by peso-paid Cuban workers.

Based on its recent dedollarization policies, the Cuban government seems to prefer increased "pesoization," which gives officials more formal control over the money supply and signaling. The Central Bank's reversal of its dollarization policies began with a controversy that reflected a jockeying between state and private creditor interests in connection with Cuban letters of credit. On July 16, 2003 the Central Bank decided to call in all foreign exchange held by Cuban banking institutions and to impose licensing requirements on their acquisition and use of foreign exchange.[89] (This measure and its immediate implementa-

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larization (paper presented at the conference To Dollarize or Dot to Dollarize: Exchange-Rate Choices for the Western Hemisphere, North-South Institute, Ottawa, Canada, Oct. 4–5, 2000), *available at* http://www.nsi-ins.ca/ensi/pdf/12_dean.pdf.

87. Even liberal proponents of central bank independence recognize the downside of abdicating monetary sovereignty to a foreign currency, either through formal adoption of the foreign currency or by pegging the value of the domestic currency to the foreign currency. *See* Colares, *supra* note 10, at 171 ("First, under a currency peg, a government ceases to be able to use the exchange rate to help the economy adjust to outside shocks, such as a fall in export prices or sharp shifts in capital flows. Instead, domestic wages and prices must adjust.").

88. *See* Ritter, Unifying Cuba, *supra* note 70, at 16–17.

89. Banco Central de Cuba Resolution No. 65/2003 (July 16, 2003). The Resolution imposes licensing requirements whenever a Cuban bank wants to use foreign exchange. *Id.* art. 8. The Resolution also calls in all foreign exchange held by state entities, *Id.* art. 3–4, presumably to increase the central government's foreign exchange liquidity. The Resolution does not apply to firms financed with foreign or mixed capital. *Id.* art. 3. Importantly for foreign investors and creditors, the Resolution clarifies that it does not interfere with contracts made with foreign entities or with the settlement of debts requiring settlement in foreign exchange. *Id.* arts. 7–8. For a discussion of the Resolution, see Philip Peters, *Cuba Imposes New Foreign Exchange Controls,* HAVANA JOURNAL,

tion demonstrate how a centralized authority still manages the island's foreign exchange liquidity.) The measure further served to increase the riskiness of credit exposures by foreign banking firms to Cuban credit institutions. The reaction to such may serve, however, to illustrate modest rent-seeking by these foreign banking firms. Upset by the currency controls imposed through the measure, these foreign banks refused to honor confirmations of letters of credit issued by Cuban banks.[90] The Central Bank capitulated, swiftly enacting Resolution 68 on July 23, 2003, that reassured foreign lenders the Resolution would not block payment by Cuban banks to the confirming banks.[91] Assuaging private creditor interests in this fashion, Resolution 68 may represent a successful attempt by a nascent finance sector to get sectoral protection. In other words, the sector sought a rent from the Central Bank in the form of a state promise not to interfere with a pre-existing contract, in this case a letter of credit.

Through a series of recent exchange rate interventions in this triple currency monetary system, the Cuban government has further reduced the importance of the U.S. dollar for domestic transactions. First, in 2004, the Central Bank eliminated the use of the dollar as medium of exchange and imposed a 10% surtax on converting dollars into convertible pesos.[92] In March 2005, the Central Bank devalued the exchange rate for the convertible peso against the nonconvertible peso (a domestic exchange rate because neither peso is used as money outside of Cuba).[93] One week later, the Central Bank abandoned parity

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Aug. 4, 2003, *at* http://www.havanajournal.com/business_comments/815_0_4_0_Ctellafriend.php781.

90. *See* Mark Frank, *Cuba Forex Controls Have Business Sector in Uproar*, HAVANA JOURNAL, Aug. 4, 2003, *at* http://havanajournal.com/business_comments/P819_0_4_0/.

91. Banco Central de Cuba Resolution No. 68/2003 (July 23, 2003); *see also* Frank, *supra* note 90 (discussing Resolution 68).

92. Banco Central de Cuba Resolution No. 80/2004 (Oct. 23, 2004).

93. *See* Acuerdo No. 13/2005, Comite de Politica Monetaria, Banco Central de Cuba (Mar. 17, 2005), *available at* http://www.bc.gov.cu/English/Laws/Agreement_13_05.pdf. Citing the growth in commodities and services in the nonconvertible peso-denominated sector, the Acuerdo purports to revalue the purchasing power of the nonconvertible peso against the convertible peso by 7%. *Id.* On a trip to Havana the week following this

between the U.S. dollar and the nonconvertible peso effective April 9, 2005.[94]

III. ANALYZING THE CUBAN CENTRAL BANK'S INDEPENDENCE

In light of Cuba's need for longer term foreign financing, the country needs to send the right signals about foreign investment, including the message that long term exposures make sense to foreign investors. However, the Central Bank is dependent on Cuban government authorities rather than independent of them. The Central Bank's governance structure reflects this formal dependence. Three types of statutory provisions in particular determine whether a foreign investor views a central bank as independent: freedom from involuntary credit extension to the government; adequate capitalization; and job security for central bank officials.[95] As a threshold matter, formally independent central banks are subject to limits on their

revaluation, the author observed the rapid readjustment of the nonconvertible-convertible peso exchange rate. Peso-denominated prices stayed stable and consumers using the convertible peso as a payment instrument supplemented the pre-March 18 prices with more convertible or nonconvertible pesos.

94. *See* Acuerdo No. 15/2005, Comite de Politica Monetaria, Banco Central de Cuba (Mar. 24, 2005), *available at* http://www.bc.gov.cu/English/Laws/Agreement_15_05.pdf. Citing the deterioration of the dollar in global foreign exchange markets, growth in the domestic Cuban market, and improved terms of trade, the Acuerdo undertakes to create different exchange rates for the purchase and sale of dollars. *Id.* When added to the 10% exchange rate tax, the Acuerdo contributes to what is an 18% tax on any dollars exchanged into convertible pesos. *Id.* The Acuerdo also notes that the effect of depreciating the dollar against the convertible peso also—by operation of the convertible-nonconvertible exchange rate—is to upwardly revalue the nonconvertible peso against the dollar. *Id.*

95. *See* John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J.L. & PUB. POL'Y 70, 87 (1998) (identifying freedom from deficit financing, adequate capitalization, and job security for senior officials as material indicators of formal independence). Economists also consider these three factors to be informal factors when evaluating central bank independence. *See* Alex Cukierman et al., *Measuring the Independence of Central Banks and Its Effect on Policy Outcomes*, 6 WORLD BANK ECON. REV. 353, 361–69 (1992). With respect to informal factors that predict central bank independence, criteria include: (i) the personality of the central bank governor or other high government officials, (ii) the turnover of central bank officers (does not suggest independence), and (iii) the extent to which conflicts between the central bank and the government are resolved in favor of the central bank (suggests independence). *Id* at 361–67.

credit extension to the government.[96] Accordingly, reforms to increase central bank independence often start by eliminating the central bank's involuntary financing of the government.[97] Bank capitalization and employment arrangements for central bank governors and directors are also material.[98] As the following application of these three criteria demonstrates, the Cuban Central Bank lacks formal independence under each of these.[99]

A. *Central Bank's Exposure to Deficit Financing*

The Cuban State Council established the Central Bank in 1997 through Decree Law 172 (Decree-Law).[100] No document

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96. *See* Head, *supra* note 95, at 87. A comprehensive analysis by the World Bank and other economists of both legal and informal factors notes the limitations of legal formalism (be it capitalist or socialist) as an explanatory model:

> Indicators based only on the law have two problems. First, the laws are incomplete in that they cannot specify explicitly the limits of authority between the central bank and the political authorities under all contingencies. These voids are filled by tradition at best and by power politics at worst. Second, even when the law is quite explicit, actual practice may deviate from it.

Cukierman, *supra* note 95, at 355.

97. The limitations of legal formalism have been noted:

> Since the outcome of monetary policy may be strongly influenced by fiscal policy, it is essential that the Central Bank has a high degree of autonomy. To achieve this, the Central Bank Act will be amended to give the Bank a more independent position within the government. In the new act, the provision of extending credit to the government, even within the fiscal year, will be removed. The Central Bank and the government have agreed that the financing of deficits in the budget can be done by attracting funds from the capital market, and by this we mean both local and international.

Suriname: Wealth Beyond Its Measure, LATINFINANCE, Sept. 1998, at 40.

98. Head, *supra* note 95, at 87.

99. Independence may contravene socialist legality that values redistributive goals and state coordination over principles of contract and private property. Gallousis, *supra* note 47, at 85 ("In relation to foreign investment codes, socialist legality values social public policy and legal flexibility over capitalist market reforms and the competing legal principle of *stare decisis*. In choosing to do so, the socialist states sacrifice predictability and stability in the law and its application.").

100. DECRETO-LEY 172 (1997) (Cuba). The Central Bank assumed the central bank functions previously exercised by the National Bank of Cuba, established through Law No. 13 of 1948. *Banco Nacional de Cuba*, BANCO CENTRAL DE CUBA, *at* http://www.bc.gov.cu/English/commercial_banks.asp (last visited Apr. 10, 2005). Socialist countries tended to consolidate both central and commercial banking functions into a

issued by the Cuban government notes whether the Central Bank was intended to be independent. Formal analysis of the Central Bank, however, necessarily starts with the Decree-Law.[101] Article 1 of the Decree-Law purports to create an autonomous entity with independent legal personality: "The Cuban Central Bank is fully autonomous and has independent legal personality and its own financial estate . . ."[102] However, Article 20 contravenes the first criterion for independence because the State Council may direct the Central Bank to fund

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single government entity. The purpose of Cuban banking reforms was to disaggregate banking activities into functionally differentiated entities responding in part to the functionally differentiated approaches of the global banking system. *See*, CUBA AT A CROSSROADS, *supra* note 12, at 253. For example, in Decree-Law 173, enacted the same day as Decree-Law 172, the State Council provided that foreign banks may establish representative offices in Cuba. *See* DECRETO-LEY 173 arts. 1, 6–7 (1997) (Cuba).

101. Unlike statutes passed by the National Assembly, decree-laws may be enacted by the State Council only in between the National Assembly's legislative sessions. CONSTITUCION DE LA REPUBLICA DE CUBA art. 74 (Cuba). The Cuban Constitution of 1972 created the Council of State, a body with executive and legislative functions composed of cabinet-level ministers and presided over by the President of the Republic. *Id.* arts. 89–94; *See also* COLECTIVO DE AUTORES, TEMAS DE DERECHO ADMINISTRATIVO CUBANO 66–71 (María Celia Guerra Pérez ed., 2004). Legal commentators have questioned whether as a formal matter a decree-law is inferior in legal rank to a law, but the National Assembly seems to have resolved that question for practical purposes with respect to Cuban sources of law by providing that the State Council's decree-laws may modify or repeal laws enacted by the National Assembly. *See* FERNÁNDEZ BULTÉ, TEORÍA DEL ESTADO Y DEL DERECHO: TEORÍA DEL DERECHO 168–71 (2004). Although Cuban courts consider jurisprudence written by legal academics and practitioners a supplemental source of law, little scholarly writing exists on Cuban law by island academics. Fernández Bulté's treatise is an example of an influential manual used widely for both teaching and practice. For a discussion of the decree-law as a source of law in Latin America, see M.C. MIROW, LATIN AMERICAN LAW 195 (2004). Mirow notes two types of decree-laws, those issued by military governments shortly after a coup and those promulgated constitutionally. *Id.* In line with Mirow's distinction between these different types of decree-laws, Fernández Bulté explains the constitutional nature of Cuban decree-laws as a function of socialist legality:

> Allow me to also mention what are called Decree-Laws or Law-Decrees in the bourgeois systems. These legal instruments have always been ways to mock the law and the constitution; legal rules enacted by executive officials, nearly always by de facto governments, through which these governments try to displace the legislative powers of parliament, and which may be confused with our Decree-Laws, which have unquestionable constitutional legitimacy and support.

BULTÉ, *supra*, at 170 (translation by author).

102. DECRETO-LEY 172 art. 1 (1997) (Cuba).

the Cuban government's deficit spending: "The Cuban Central Bank may not issue currency in order to finance a deficit between revenues and expenditures of the State Budget, *except as determined by the Council of State within the limits established by that organ*."[103]

In other words, the government may direct the Central Bank to create money to finance deficit spending whenever governmental receipts fall short of disbursements. Exposed this way to the political short run, the Central Bank becomes a conduit for the State Council's preferences about the money supply and rate-setting. Under this legal arrangement, peso price stability—and that of assets and liabilities valued in pesos—is unlikely, because the Central Bank lacks control over the money supply and hence, inflation.

Despite the government's lack of inflation data[104] and the difficulty of evaluating real inflation due to the use of multiple currencies,[105] peso inflation has been a long-standing problem in Cuba.[106] Financing Cuba's budget deficit through money creation produced ongoing peso inflation during the early 1990s.[107] Although not reflected in official estimates, the Cuban peso experienced high real inflation between 1990 and 1995, and continues to deteriorate as measured by the rising real costs of obtaining basic foodstuffs and other household goods in an

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103. *Id.* art. 20 (emphasis added).

104. *See* Ritter, Unifying Cuba, *supra* note 70, at 11.

105. *See id.* at 17.

106. President Castro addressed peso inflation in 1972 soon after the announcement that Cuba would join CMEA:

> But, you see, we have a big problem: we have to collect the surplus money in circulation. It is not good for so much money to be circulating. It causes inflation, and that is bad. We must develop a policy aimed at collecting all that money. Insofar as the essentials are concerned, though, there will be no change in our policy on principles. Our policy will always be based upon the principles of Marxism-Leninism and proletarian internationalism.

Interview by Marta D. Solis with Fidel Castro, President of Cuba, in Garden of the Polish Embassy, Havana (July 23, 1972).

107. *See* Ernesto Hernández-Catá, *Julio Carranza and Pedro Monreal on Economic Change in Cuba: A Critique*, *in* 5 CUBA IN TRANSITION: PROCEEDINGS OF THE ANNUAL MEETINGS OF THE ASSOCIATION FOR THE STUDY OF THE CUBAN ECONOMY (Aug. 1995) (held at Florida International University, Miami, Fla., Aug. 10-12, 1995), *at* http://lanic.utexas.edu/la/cb/cuba/asce/cuba5/FILE02.pdf.

increasingly "dollarized" economy .[108]

Another aspect of monetary independence from the central government related to deficit financing is the scope of a central bank's freedom to shape monetary policy—a central focus of central bank law.[109] Predictably, the Central Bank's authority over monetary policy is limited.[110] The Central Bank's techniques for implementing monetary policy include: directly setting interest rates; setting reserve requirements; managing banking system liquidity; issuing its own obligations; and making collateralized, short-term loans to banks facing liquidity problems.[111] By adjusting commercial banks' liquidity, these transactions affect lending resources—and hence, the money supply—by impacting the volume of retail and commercial credit.

However, the Central Bank may not implement policy freely. Instead, the State Council must approve the Central Bank's monetary policy recommendations. [112] This politically

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108. *See* Ritter, Unifying Cuba, *supra* note 70, at 11. The peso surplus caused by deficit financing through money creation increased prices for consumer goods. "Such rising prices constituted by definition inflation, even though the official position until recently was that there was no inflation because of the price controls on the rationed goods and services." *See* Ritter, *Dual Currency*, *supra* note 70, at 117.

109. *See* Jorge Guardia, *Banking Law Developments in Latin America*, *in* 4 CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS 159 (1997) (reviewing central bank laws for Argentina, Chile, Colombia, Mexico, Uruguay, and Venezuela). Most central banking laws from other Latin American countries instead address monetary policy. *Id.*

110. The Decree-Law addresses monetary policy in Article 3:

> The Central Bank's objectives are to oversee the stability of the national currency's purchasing power; to help the economy to achieve equilibrium and develop in an orderly way; to have custody of and administer the country's international reserves; to ensure the normal functioning of internal and external payments; to exercise functions related to the discipline and supervision of the banks, non-banking financial institutions and representative offices whose establishment in the country is authorized; and to carry out any other functions which the laws entrust to it.

DECRETO-LEY 172 art. 3 (1997) (Cuba).

111. *Id.* art. 16–17. A reserve requirement is liquidity—a contra-asset account, in accounting terms—which the Bank must set aside based on a subset of the Bank's liabilities. *Id.* (In other words, reserve requirements are a transaction cost to the Bank of funding itself through issuing liabilities.). The Central Bank may inject liquidity into the banking system by reducing the amount of reserve requirements. *Id.*

112. In 1998, the Central Bank president formed a Monetary Policy Committee to

sourced uncertainty about the money supply creates risk for any foreign investor holding a peso-denominated investment because its value may fluctuate unpredictably.

B. Capitalization and Appointment Tenure

Given the significance of the Central Bank's vulnerability to state imposed requirements to fund deficits, this feature alone would justify a formalist or legal process conclusion that the institution lacks independence. The Decree-Law's provisions on capital structure and appointment corroborate this conclusion. Independent capitalization is the second test for central bank independence.[113] Central bank capitalization matters to potential foreign investors because it signals whether the institution can fund its monetary liabilities and other obligations, such as debts, and whether the institution can survive financial difficulties without requesting more funding from the government.[114] Under Article 6 of the Decree-Law, the Central Bank capitalization consists solely of a contribution of an unspecified amount from the state and an unspecified minimum reserve. Decree-Law 172 states, "[t]he capital of the Cuban Central Bank is formed by a capital contribution by the State and the legal reserve, which must meet a minimum capital requirement."[115] This provision lacks clarity about the depth and liquidity of the institution's capitalization and the accounting treatment of future earnings and losses. As a result, potential counterparties cannot determine the net worth—and hence, their counterparty risk to the institution—of the Central Bank.

The final criterion for independence considered here is the

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advise on the formulation and implementation of monetary policy. *See Monetary Policy*, BANCO CENTRAL DE CUBA, *at* http://www.bc.gov.cu/English/mon_policy.asp (last visited Apr. 10, 2005).

113. Head, *supra* note 95, at 87.

114. *Id.* at 81–82.

115. DECRETO-LEY 172 art. 6 (1997) (Cuba). Compare, for example, the central banking statute of Bosnia and Herzegovina, adopted at approximately the same time as the Decree-Law. The Bosnian statute details the central bank's capital structure, including provisions for allocating annual profit and loss and for covering potential capital deficits. *See* Legislation of the Central Bank of Bosnia and Herzegovina, Ch. 3, arts. 25–30 (1997), *at* http://www.cbbh.ba/en/regulations.html [hereinafter Legislation of the Central Bank].

tenure of a central bank's officers. The greater the employment security of an official, the greater that official's freedom of action.[116] Expressed in terms of the rent-seeking model discussed in Part I, indefinite tenure provides incentives for an official to seek rent in the form of employment security. Yet, no Cuban Central Bank officer enjoys the relatively certain tenure of a term appointment. The State Council and the Council of Ministers may remove officers for failure to comply with their statutory duties.[117] However, neither the Decree-Law nor the Constitution imposes process constraints for removal. Indefinite tenure subject to removal by government officials makes these officers accountable to these officials and their monetary policy preferences. Nevertheless, Francisco Soberón Valdés has served as the Central Bank's first president continuously since his term began on January 23, 1997.[118]

IV. COLLATERALIZED GOVERNMENT BORROWING TO SIGNAL FISCAL SELF-BINDING

The Cuban Central Bank's failure to signal openness to long term rent-seeking through structural independence does not send a favorable investment signal. Given the importance of increasing foreign financing and recognizing the potential value of signaling to this end, the Central Bank should conduct a collateralized government borrowing.[119] As suggested by the argu-

116. Head, *supra* note 95, at 87.

117. DECRETO-LEY 172 art. 50 (1997) (Cuba). In contrast, the Bosnian Central Bank law provides that the term of each governor is six years and that he may be removed only upon election to a public or executive office, criminal conviction, personal insolvency, or for personal misconduct. Legislation of the Central Bank, *supra* note 115, ch. 2, arts. 8, 11. Only the Bosnian President may exercise the power of removal for cause. *Id.* art. 11.

118. *See About the BCC,* BANCO CENTRAL DE CUBA, *at* http://www.bc.gov.cu/English/about_bcc.asp (last visited Apr. 10, 2005). The strong personality of the Cuban President is a matter of public knowledge. The same cannot be said for the Central Bank president, Francisco Soberón, although he has served continuously since his appointment in 1995, potentially suggesting some measure of institutional independence. *See Id.*

119. Central Bank President Francisco Soberon recently sent a financial signal by announcing of a budget surplus. *See* Associated Press, *Cuban Central Bank Chief Says Island Sees First Surplus in Decades*, GLOBAL EXCHANGE, Mar. 29, 2005, *available at* http://www.globalexchange.org/countries/americas/cuba/2975.html. Unfortunately, the

ment that rent-seeking influences public financing decisions, opportunities for mutually beneficial arrangements between officials and financial sector interests—and not the relative policy merits of this proposal—will predict its adoption. This recommendation deliberately avoids questions of internal Cuban sovereignty in order to model a discourse that focuses on the contractual expectations of market counterparties. While liberalization advocates often link economic liberalization to democracy reforms, liquid collateral makes possible transactional certainty regardless of the counterparties' respective political economies.[120]

Given Cuba's subinvestment country credit rating and the ongoing pattern of unpredictable government actions which disrupt commercial expectations, the Central Bank's ability to meaningfully signal is substantially impaired. Because central bank independence may be too highly associated with liberal market economies, a discrete transaction replicating fiscal self-binding on a small scale may provide an acceptable alternative to the Cuban government.

In an asset-backed securities issuance, the government would deposit liquid collateral and receivables into a special purpose vehicle, which would then issue securities. Assuming ade-

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announcement has limited signaling value because the announcement does not quantify the surplus nor explain the budgeting methodology used to determine the surplus. The announcement is more a political rather than a market signal.

120. Market reform recommendations for socialist countries fall into two camps: those which conclude central planning is incompatible with market mechanisms and those which selectively incorporate market reform elements within socialism. *See* Pérez-López, *Foreign Investment in Cuba*, *supra* note 49, at 239–44. The collateralized debt proposal is an example of the latter, which is also the view ascribed by Peréz-López to the Cuban government in its 1990s liberalization reforms. *Id.* A market-friendly proposal such as this, though, may alarm some progressive legal academics concerned about the track record of liberal reforms in Latin America. For example, by giving foreign creditors preference on government liquidity over claims of other creditors—including Cubans living on the island—this deal raises fairness questions not considered here. In Cuban area studies, the negative experience of other countries with liberal reforms must be considered in light of Cuba's longstanding exclusion from markets. Progressive academics should consider that the prospect for socialist adaptation to a market economy may be greater in the case of Cuba than it has been for countries that were already integrated into a market trading system. For similar reasons, rent-seeking—though typically viewed as undesirable for policy reasons—may have welfare effects in the case of Cuba.

quate collateralization, the credit quality of some of these securities would exceed Cuba's current subinvestment grade credit rating. Given the country's current illiquidity, earmarking expropriation-proof collateral and receivables would require a fiscal sacrifice.[121] To insulate foreign investors from any governmental attempt to claw back the collateral, an escrow account could be set up with a foreign trustee to hold the collateral.[122] Such a collateral arrangement would put to rest both investors' liquidity risk and political risk concerns based on Cuba's history with default due to expropriation.

Though not as significant a precommitment mechanism as an institutionally independent central bank, collateralized debt issuance involves fiscal self-restraint to the extent the government sacrifices a current liquid revenue stream in favor of funding a longer term obligation. Successfully floating one collateralized government borrowing would send a significant signal to market counterparties with investment demand in Cuba. Moreover, the deal structure proposed in this Part would, among other things, give the Cuban Central Bank experience with a state-of-the-art funding structure, asset-backed securities.

The Central Bank could also increase transparency simply by publishing its balance sheets periodically. In evaluating that recommendation, the Central Bank would have to consider the tradeoffs involved in making its balance sheet more transparent. Without transparency, the Central Bank might save on

121. Complete liquidity funding of the vehicle before issuance would result in the highest bond rating for the securities. To the extent that any funding of the vehicle is done on a forward basis or in installments, opportunities for breach exist.

122. By transferring the collateral to an off-shore trustee beyond Cuba's territorial jurisdiction, the Cuban government would be—like Ulysses, see discussion *supra* note 25—unable to change its mind and recover the collateral in the future in jurisdictions which recognize territorial limits on a sovereign's power to expropriate. For example, U.S. courts will generally respect a sovereign's attempt to expropriate property as an act of state only if the property is in the territory of the sovereign. *See* Lee C. Buchheit, *Act of State and Comity: Recent Developments*, *in* JUDICIAL ENFORCEMENT OF INTERNATIONAL DEBT OBLIGATIONS 96 (D. Sassoon & D. Bradlow eds., 1987). *Cf.* Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964) (applying the state doctrine to the Government of Cuba's expropriation of sugar located in Cuba's territorial waters) In *Sabbatino*, the property in question was in Cuba's territorial jurisdiction. *Sabbatino*, 376 U.S. at 401.

borrowing costs in the short run by (opportunistically) exploiting the information asymmetry about state finances. In the long run, more transparency about the government's global financial position is needed to increase foreign investment as well. A regularly published balance sheet would reduce the information costs to potential investors. The simplest way to increase transparency about the Central Bank's financial condition would be to publish the Central Bank's balance sheet regularly.

V. RECOMMENDATIONS TO U.S. AUTHORITIES

The Cuban authorities could unilaterally implement the proposal discussed in Part IV. However, U.S. law imposes major legal obstacles on the Cuban government's ability to develop and maintain its financial signaling media. Accordingly, this Part will make some recommendations as to reforms which U.S. lawmakers may want to consider in order to increase the Central Bank's freedom of action over public financing and financial market signaling.

A. Repeal of the Johnson Act

According to the legislative history of the Johnson Act,[123] its main purpose was to protect U.S. citizens from acquiring foreign securities whose risk of default was difficult to evaluate because of lack of information.[124] Although these restrictions may have served U.S. investors in their day, the Johnson Act now limits the portfolio management and investment preferences of U.S. and other investors, who, depending on their portfolio, might reduce systemic investment risk through holding Cuban debt. Commentators agree that the Johnson Act should be repealed because it fails to accomplish its stated goals, and, instead, creates legal uncertainty for lenders trying to comply with the Johnson Act.[125] Moreover, Cuban debt would contribute to the

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123. *See supra* note 74 (discussing the Johnson Act).

124. *See* Charles O. Prince III, *The Johnson Debt Default Act: How to Comply with What's Left*, 98 BANKING L.J. 147, 148–49, 152 (1981).

125. *See id.* at 164–65; *see also* Committee Report by the Committee on Foreign and Comparative Law of the Association of the Bar of the City of New York, *The Johnson Act Should Be Repealed* (1979), COMMITTEE REPORTS 1979–80, 35 REC. AB CITY NY 47–48 (Oct. 1980).

depth and liquidity of U.S. capital markets, founded on a commitment to be an internationalized market.[126]

This Article provides further support for repeal. The Johnson Act was enacted before the implementation of the statutory disclosure standards for foreign sovereigns contained in Appendix B of the Securities Act of 1933.[127] Accordingly, several legal and market changes since 1934 have eliminated the original evil that prompted the statute, that is, information costs to U.S. investors of sovereign debt obligations. Securities rating agencies now provide detailed information about the payment probabilities of foreign sovereigns. The development of asset-based securitization—spurred in part by the Brady Plan—means that governments can issue asset-based bonds that are more creditworthy than the general obligation bonds issued by sovereigns at the time of the Johnson Act. Moreover, the migration of sovereign debt from commercial banks' loan books to mutual funds and other institutional investors spreads the risk that unwitting investors will run afoul of the Johnson Act by inadvertently acquiring a forbidden security.

Increased membership of sovereigns in both the IMF and the IBRD has narrowed the universe of countries subject to the Johnson Act exclusively to Cuba and North Korea. The Johnson Act also keeps U.S. investors from making direct foreign investments[128] that might strengthen the commercial ties between the United States and any delinquent debtor nation. Finally, since the adoption of the Johnson Act, Congress has given the Executive branch a broad range of economic sanctions[129] providing more nuanced effects than the blunt prohibitions of the Johnson Act. As a result of these factors, the financial social costs of the Johnson Act are no longer justified.

126. Securities Exchange Act of 1934, 15 U.S.C. § 78a (1934) (providing specific provisions in Section 2, 30, and 30A, for foreign transactions and authorities).

127. Securities Exchange Act of 1933, §77aa, 15 U.S.C. § 77a (1933).

128. 18 U.S.C. § 955 (2000).

129. *See, e.g.*, International Emergency Powers Act (IEEPA) § 1702, 50 U.S.C.A. §§ 1701, 1702 (West 2003 & Supp. 2004).

B. Facilitating Access to Foreign Exchange Swap Lines for Currency Stabilization

Effective government borrowing programs also benefit from currency stabilization programs to preserve the foreign exchange value of the currency in which the country borrows.[130] As part of currency stabilization, central banks enter into swap lines of credit with other central banks and financial intermediaries to acquire foreign exchange to fund currency stabilization. These swap lines are the principal transactions a central bank conducts as part of its international activities. Section 3 of the Decree-Law is the main source of the Cuban Central Bank's authority over international activities.[131] The Decree-Law provides the Cuban Central Bank with ample authority to conduct these liquidity transactions,[132] but the Central Bank's relationships with other central banks is hampered by the legal disability imposed by U.S. law. U.S. law most dramatically keeps the Central Bank from exercising the sovereign functions proper to any central bank. The Cuban Assets Control regulations[133] keep the Central Bank from establishing the swap credit lines discussed above with the full market of financial intermediaries, despite the willingness of certain firms to risk noncompliance by swapping with the Central Bank notwithstanding the legal risk from U.S. regulation.

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130. Obviously, this is not an issue to the extent that Cuba becomes more fully dollarized.

131. DECRETO-LEY 172 art. 25(c)–(d) (1997) (Cuba).

132. *Id.* For example, Cuba does not participate in the Bank for International Settlements (BIS), a multilateral forum for central bank cooperation. Bank for International Settlements, *Organisation and Governance*, *at* http://www.bis.org/about/orggov.htm#pgtop (last visited Apr. 10, 2005). The purposes of the BIS are to

> promote the co-operation of central banks and to provide additional facilities for international financial operations; and to act as trustee or agent in regard to international financial settlements entrusted to it under agreements with the parties concerned.

Statutes of the Bank for International Settlement art. 3 (1930) (amended 2003), *available at* http://www.bis.org/about/statutes.htm. Countries participate in the BIS by invitation, based on "the desirability of associating with the [BIS] the largest possible number of central banks that make a substantial contribution to international monetary co-operation and to the [BIS]'s activities." *Id.* art. 8(3). If Cuba can meet this standard, the country would have a basis for requesting an invitation to join the BIS. *See id.*

133. 31 C.F.R. § 515.201 (2004).

VI. CONCLUSION

The impact of creditor interests on central bank design—and other public institutions—may be appreciated from institutional analyses concentrated historically on private firm structure. Despite the deeply contemptible restraints on Cuban area studies, scholarship should begin to create a discourse forum for public questions about Cuban nationality and market structure free of the diseconomic projects associated with much of the Cuba "transition" movements. The role of educational institutions is to counter federal, and other, restraints on academic freedom and to pursue scholarship and activism—including market structure reform activism—consistent with a modern vision of the Cuban state.

Conventional axioms of government design, like the central bank independence hypothesis, may describe outcomes in a developed country, but these axioms need critical review before becoming normative standards for less developed countries. Identifying the governance structure of rent-seeking deals between central banks and their constituencies shows how private creditor interests impact the workings of financial regulations. To that end, using opportunism to model individual and institutional action makes theory more relevant, especially that of liberals, progressives, and deconstructionists on the left (island, diaspora, and elsewhere).

Admittedly, neither the Cuban Central Bank nor U.S. lawmakers will likely implement the recommendations made here any time soon. In the meantime, island, diaspora, and other scholars should focus attention on the public questions implicit in the Cuban credit market. Given the resources of the U.S. legal academy, individual U.S. academics should nurture ties with Cuban academics and, in this way, integrate the Cuban legal academy into the global academic market. Relatedly, the leadership at U.S. academic institutions should resist, oppose, and denounce the suffocating limits currently in place on academic freedom in Cuban area studies. Transition, after all, begins at home.