INVESTMENT AND SOVEREIGN RESEARCH

SOVEREIGN: CUBA

PLEASE REFER TO EXPLANATIONS ON RECOMMENDATIONS CONTAINED IN APPENDIX BELOW

Table 1: Cuba's SWOT Analysis

Strength

- Large well-educated workforce relative to other countries in Latin America and the Caribbean
- Proximity to the US and an emerging competitive tourist destination in the Caribbean
- Cuba's healthcare and biomedical systems are highly developed, and the health sector's professional technicians are well trained.
- Locally developed Covid-19 vaccines show a high rate of efficacy in protection against the disease

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Weakness

- Heavily dependent on tourism from the US and dependent on Venezuela and Russia for oil imports
- A heavy concentration of primary exports–nickel and agriculture- exposes the country to international price volatility.
- Lockout of the international capital market and is reliant on monetising government deficit; US embargo on Cuba hinders foreign direct investment.
- Regional allies Venezuela and Nicaragua face economic and political pressure limiting their ability to provide economic support to Cuba.

Opportunities

- Easing of the relationship with the US and ultimately an end to the embargo could open doors for a greater level of external private investment.
- A gradual shift in the liberalisation of Cuba's industries will increase opportunities for private sector investors. Unification of dual currency system and small business ownership are incremental steps towards unlocking greater private sector participation in the economy.

Threats

- Failure of the Biden Administration to ease economic sanctions imposed by the Trump administration could slow growth and limit foreign exchange flows, this could limit Cuba's economic recovery and exacerbate the sovereign's shortage of foreign currency.
- Exposure to hurricanes poses a severe threat to the sovereign's infrastructure and disruptive to economic activities.
- An increase in Covid-19 variant cases that are resistant to vaccines could cause more lockdown measures to be imposed and draw out the pace of economic recovery.

Summary

Following a sharp contraction in 2020, Cuba's economy is set to expand in 2021 through to the medium term. Growth in tourism and domestic commerce are expected to drive growth. The relationship with the US remains tense but could ease. However, the shift in Latino voting patterns in the last presidential election may hinder President Biden from rolling back Trump-era sanctions on Cuba soon. Cuba's President Miguel Díaz-Canel is reform-minded, but a sharp policy shift towards a more market-friendly economic system could cause contention in the Communist Party. Although young people in Cuba are clamouring for change, Mr Díaz-Canel will have to make concessions to appease various groups. Cuba is ripe with investment opportunities, but the embargo is holding back private investments. Over the long run, there may be a change as US businesses look for more markets and virgin territories to expand.

Real GDP Growth

We expect Cuba's economy to expand by 2.7% in 2021 and 4.5% in 2022. This positive growth outlook follows a sharp contraction in output of 11% in 2020, due primarily to a decline in tourism, severe shortage of foreign currency and US sanctions. Visitor arrivals declined by 1.1 million visitors (74%) in 2020 due primarily to targeted US sanctions and restrictions on movements of persons imposed by the government to curtail the spread of Covid-19. The growth outlook reflects improvement in tourism and the gradual easing of Covid-19 restrictions on movements of persons, which will help buoy domestic commerce. It also factors in the likelihood of overseas sale of Cuba's two domestic Covid-19 vaccines—Soberana 2 and the Abdala - both of which have a high efficacy rate. However, the World Health Organisation has not yet approved their use.

Figure 1: Selected Macroeconomic Data for Cuba

Indicator	2016	2017	2018	2019	2020	2021 (e)	2022 (f)	2023 (f)	2024 (f)
Nominal GDP per capita, USD	8,060.8	8,541.2	8,824.2	9,099.7	8,521.3	1,895.3	2,598.7	3,007.9	3,237.0
Real GDP growth, % y-o-y	0.5	1.8	2.2	-0.2	-11.0	2.7	4.5	3.4	2.5
Unemployment, % of labour force, average	2.0	1.7	1.7	1.2	3.0	3.0	3.0	3.0	3.0
Balance of goods and services, % of GDP	2.7	2.9	1.4	1.2	2.6	-19.2	-15.4	-12.4	-11.2
Current account balance, % of GDP	2.0	2.0	0.4	0.3	1.6	-20.1	-16.4	-13.4	-12.2
Trade in goods balance, %of GDP	-8.5	-7.8	-8.9	-7.4	-5.4	-29.2	-25.5	-22.6	-21.6
LCU/USD, average	1.0	1.0	1.0	1.0	1.0	24.0	24.0	24.0	24.0
Total revenue, % of GDP	56.3	57.6	57.6	57.7	57.7	57.4	57.6	57.6	57.6
Total expenditure, % of GDP	63.3	66.0	65.5	63.8	69.6	66.9	65.0	64.8	64.7
Capital expenditure, % of GDP	3.7	4.2	4.8	4.8	5.3	4.6	4.7	4.7	4.7
Current expenditure, % of GDP	59.6	61.7	60.6	59.0	64.3	62.3	60.4	60.1	60.0
Budget balance, % of GDP	-6.7	-8.6	-8.1	-6.2	-11.9	-9.5	-7.4	-7.2	-7.1
Consumer price index inflation, average, % chg y-o-y	0.9	-0.2	-3.0	2.3	3.0	500.0	30.0	10.0	4.0

Sources: Fitch Connect and JMMBIR

US Sanctions

US-Cuba relations could improve under the Joseph Biden administration. However, domestic politics could force the administration to maintain the policies enacted under the Trump administration with little change. The relationship between the two countries improved under the Obama administration, which saw the US easing travel restrictions and remittance flows to Cuba. However, the Trump administration rolled back most of the previous gains and maintained a frigid relationship with the Cuban government. The US administration invoked Title III under the Helms-Burton Act, allowing US citizens and companies to sue in a US court any person or company that deals in property previously held by the US citizen but was confiscated and nationalised by the Cuban government after the 1959 revolution.

Although the Joe Biden administration may desire to improve its relationship with Cuba, the results of the poll in Florida from the presidential election held in 2020 is likely to force careful reconsideration regarding how the administration deals with Cuba. The Republican Party garnered the largest share of the Latino-American voters who traditionally sided with the Democratic Party. Fear-mongering aside, concerns about the thawing of the relationship with Cuba under a Democratic president may have influenced how persons of Latino origin voted in the election. Cognizant of this and to improve relations with this voting bloc, the Biden administration may put Cuba on the back burner. Thus, they may not be in any haste to change the status quo regarding the US-Cuba relationship in the short run. This means that restrictions on investments is likely to persist for at least another year. Where we might see improvement is in the relaxation of tourism and remittance flows.

Tourism and Remittance Flows

Tourist arrivals declined by over 74% in 2020 because of a combination of the Covid-19 pandemic and US sanctions. Likewise, there was a decline in remittance flows in Cuba whilst there was an increase in some of the most remittance-dependent Caribbean nations, including the Dominican Republic, Guyana and Jamaica. Improvements in global growth culminating with a higher level of vaccination in source countries for tourism will help drive visitor arrivals and growth in tourism in H2:21. Although indications are that visitor arrivals were relatively more upbeat during the first half of the year compared to 2021, visitor numbers remained subdued due mainly to restrictive movements of persons and US sanctions. In Q1:21, there was an uptick in Covid-19 cases in Cuba, mainly Havana, forcing the government to implement stringent lockdown measures to curtail the spread of the disease.

The government carried out trials on two local vaccine candidates and announced a 92% efficacy in June for one, the Abdala. With the availability of the vaccines and Cuba's relatively efficient public health system, we expect that over 80% of the adult population will be vaccinated by the latest October. We envisage the gradual easing of restrictions of movements and a return to normality in the Cuban society by Q1:22. This development reinforces our outlook on tourism as it is likely to affect tourism growth and related activities positively in H2:21 and subsequent periods. The downside risk is that the Biden administration may not ease some of the restrictive measures imposed under President Trump. Thus US visitor numbers may not return to the pre-pandemic level any time soon.

With the restrictions in place, we expect remittance flows to remain subdued over the medium term. As with tourism, we believe that domestic US politics will weigh on the Biden administration reversing restrictions imposed by Mr Trump. Our base case estimate is that there is no policy shift. If there is a change, it will have a positive effect on domestic consumption and help ease the country's chronic shortage of foreign currency.

Fiscal Policy and Debt

At over 57% of GDP, revenue to GDP is the highest in Latin America and the Caribbean (LAC) because of the central planning nature of Cuba's economy. Revenue plummeted in 2020 as economic activities declined, but we believe it will expand with growth in the economy. We expect the share of revenue to GDP to remain stable over the medium term. Leading up to the resignation of Raul Castro in 2018, the Cuban government ran a fiscal deficit averaging 7.3% over four years, including 2018. We surmise that the high spending was to help preserve social harmony and a smooth transition of power from Mr Castro to Miguel Díaz-Canel, a more reform-minded president than his predecessors. Revenues plummeted during the pandemic, but spending remained elevated, with increased outlay on social support and healthcare. Because of this, the fiscal deficit jumped from 6.6% in 2019 to 11.9% in 2020. We expect the deficit to fall in subsequent periods but should remain elevated, leading to increased debt levels.

After a series of debt defaults, Cuba remains a pariah in the international capital market. The deficit is monetised or funded through a combination of bilateral loans and loans from state banks. The government has admitted that monetising the debt is inflationary and places pressure on an already weak domestic currency. Based on this line of thought, it is likely that the preferred mode of financing is through bank loans from the state banks, as Cuba does not have a thriving domestic capital market from which to borrow the amount of resources required to finance the deficit. However, the funding strategy is not sustainable, as it is likely that the banks do not have the liquidity to fund the government in the long run. Data on the banking sector and debt are sparse or non-existent. It is challenging for us to get an exact handle on the state of affairs of state banks and the level of funding given to the state or to forecast Cuba's debt level.

External Balance

Cuba generated a current account surplus of 1.6% in 2020 due to slowing demand for imports and high demand for medical services from LAC countries. We, however, expect the surplus to turn to deficits over the medium term. In January 2021, the government unified the dual exchange rate system, which effectively devalued the convertible pesos. The convertible pesos is pegged to the US dollar. This will realign the value of the convertible pesos with the national pesos. The devaluation of convertible pesos will help to boost exports. However, we still expect Cuba to generate a deficit in goods trade. Economic decline in Venezuela and US sanctions on shipping between both countries will curtail export growth. Venezuela accounts for over 40% of Cuba's goods exports. On the import side, with Venezuela's oil industry facing severe challenges and the country in need of hard currency, Cuba will have to source most of its oil on the international market at a higher price. Higher oil imports and subdued exports to Venezuela will influence the trade balance. The Cuban government emphasises using bilateral trade deals as a conduit to improve Cuba's exports.

We expect that strong growth in tourism and medical services will allow Cuba to maintain a surplus position in the services over the medium term. While not considered in our base forecast, improvements in relations with the US would lead to higher tourism and higher service surplus over the forecast period. Notwithstanding the positive growth in services, envisage a current account deficit over the forecast horizon.

Reforms

Market reforms hold the key to unlocking higher levels of growth in the Cuban economy. Cuba made progress immediately after 2011 when the government announced reforms, but these reforms have fallen significantly short of expectation. Over the long run, we expect Cuba to transition to a market-driven economy, with the communist party maintaining a tight grip on political activities and control over some businesses. Re-write of the Constitution allowing for more market-friendly activities and, more recently, unification of the dual exchange rate system are small steps and signals of the Cuban government to move towards a more liberal economic system in the long run. We envisage that the country will seek to strengthen economic and trade ties with CARICOM, Latin America, and Europe.

However, our outlook is fraught with challenges as Mr Díaz-Canel may meet opposition from more hard-line members of the Communist Party, and US sanctions could hinder investment flows. Mr Díaz-Canel does not have the appeal and political connections as the Castro brothers. Thus, a speedy reform could enrage hard-line political elites who hold steadfast to the Revolution and view the liberalisation as a betrayal of its ideals. Therefore, Mr Díaz-Canel will have to navigate his policy path carefully and use guile to achieve his reform agenda without causing too much political noise, which could destabilise or even hinder his efforts.

We do not foresee a roll back of US sanctions over the medium term, as the political tides are not ebbing towards such a shift. A change in the voting pattern among the Latino population is a cause for concern amongst Democrats and the Biden administration, who may want to appease this group and regain support lost going into mid-term elections in 2022 and the 2024 Presidential election. However, there is a growing interest among US businesses to invest in Cuba, as reflected in the investment flows following the thawing of the relationship in 2014. Areas of interest with a potentially high return on capital are infrastructure development, telecommunication, mining, energy and tourism. However, that is insufficient to incentivise a divided Congress to roll back the Helms-Burton Act over the medium term. We expect some improvements in the US-Cuba relations, but we do not think it will be enough to drive investment flows that could push Cuba's long-term growth above the expected medium-term growth path.

Opinion

The Cuban economy remains an untapped potential with the possibility to experience high levels of growth. Still, the sovereign is mired in global politics, which will continue to provide a headwind for growth and investments over the

medium term. We expect the economy to show growth in 2021 and nominal GDP to return to 2019 levels in 2024. Already we see the government implementing gradual reforms. Cuba could transition to a more market-friendly economy over the long run. Over the medium term, however, domestic politics will limit the pace of reforms. Mr Díaz-Canel will seek to make concessions to younger Cubans who desire to change in their society and zealots who hold steadfast to the ideals of the Revolution.

Although Cuba provides an opportunity for investments in the future, population dynamics do not lend themselves to long-term sustainable growth in human capital. The Cuban workforce is more educated than most of its LAC peers, but it is also shrinking as the proportion of persons over 60 years of age increases and population growth slows. Herein lies a challenge to the country's growth potential and fiscal outcomes in the long run. Cuts in the country's social support payments could lead to tension and upheavals, which political leaders want to avoid. With government revenues as a portion of GDP already elevated, increasing revenue through taxation may be suboptimal. Market reforms that lead to increase growth and/or budget cuts are alternative options. We think the political leaders will choose market reforms, albeit gradual reforms, to appease different groups in Cuba's society.

Complete rollback of US sanctions is not likely to occur over the medium term. Still, both sides may make political concessions as business interest increases in Cuba over the long run. US corporates need more markets to expand, and Cuba needs investment to grow and rebuild its dilapidated infrastructure. Thus, the relationship could improve, bringing with it political and economic gains on both sides.

Sources:

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APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

UNDERWEIGHT—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET
SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.
HOLD/MARKETWEIGHT—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

VERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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