Productive System Segmentation and Its Impact on Internal Macroeconomic Imbalances

By Ricardo Gonzalez-Águila
Universidad de Barcelona

In this piece, I will analyze the current imbalances by incorporating a dimension that is often overlooked: the productive dimension.

The current macroeconomic crisis, particularly inflation, is not a traditional crisis that can be explained solely by demand-side factors. Of course, there is instability driven by fiscal deficits, monetary expansion, and external imbalances—this is indisputable. However, a growing part of the deficit and monetary issuance is being generated endogenously by structural and institutional productive issues that need to be addressed as part of the stabilization plan. If these issues are ignored, they will significantly undermine the plan's effectiveness.

The fiscal deficit and the productive system are linked through the price system, particularly the widespread lag in state-set prices compared to market prices set by the private sector. The price system encompasses not only the prices of final goods but also wages, exchange rates, interest rates, and the prices of intermediate inputs. A unique institutional feature of Cuba is that none of these are determined in unified markets. The segmentation between the private and state sectors leads to different pricing mechanisms. While prices in the private sector adjust freely to internal and external shocks, state-sector prices are regulated by the government, preventing them from reflecting the same market signals. The delay in adjusting state prices is directly related to the government's repeated interventions. I want to emphasize that price regulation has always been present in Cuba, but in today's inflationary context, it has been heavily relied upon to prevent further erosion of real wages and pensions.

To illustrate the extent of this lag, let us look at a few examples. While a small or medium-sized enterprise (SME) can freely buy U.S. dollars at 360 CUP per USD[1] on the informal currency market, a state-owned enterprise struggles to find dollars for imports at the official rate of 24 CUP.[2] Similarly, state-owned companies face increasing difficulty finding workers willing to accept a monthly salary of 5,000 CUP,[3] as wages in the private sector are at least three times higher. They also struggle to secure financing at the official interest rate of 7%-8% per year, while the informal rate ranges from 15%-30%. Moreover, the sales prices of state-owned enterprises do not adjust to inflation because they are regulated by the State. Although companies find ways to bypass these regulations, the adjustments never happen as quickly. For example, the price of an egg in the rationed consumer market is around 2 CUP per unit, whereas in the free market where SMEs operate, it is 100 CUP. This example is not just an isolated case, but reflects a broader trend across state-produced goods, regardless of the currency they are sold in. Naturally, the size of the gap varies depending on the relative scarcity of each good and the unique institutional characteristics of each market.

Contrary to the belief that widespread regulation benefits the state sector by keeping prices lower amid inflation, what it does is increase relative scarcity. This happens because the quantities demanded, both for final goods and production inputs, cannot be met at the regulated prices. Scarcity in the state sector is a well-known reality in Cuba that needs little verification. The mismatch between supply and demand at these regulated prices is a major reason (though not the only one) behind the current stagnation of state-run activities, and why, in the face of the same crisis, the private sector adapts and continues to operate while the state sector stalls. It also explains the severe shortages of productive inputs, profitability issues, idle capacity, and financial constraints plaguing the state sector.

The significant lag in the state-controlled pricing system creates two fiscal challenges: one on the revenue side and one on the expenditure side. As prices fall behind, less revenue is collected, not only due to the nominal impact of inflation on budget revenues, but more critically, because of the recessionary effects caused by the widening gap between market and regulated prices.

[1] It refers to El Toque's exchange rate from the last week of April 2024
[2] Official exchange rate of the economy since January 2021
[3] Approximately the average salary of the economy in 2024

It is important to note that, according to official figures, the state sector still accounts for 88% of tax revenue in Cuba; therefore, revitalizing this sector is essential to boosting fiscal revenue. The regulation of prices may help explain why fiscal revenues are expected to grow by only 19% in 2024 compared to early 2023, despite official inflation in 2023 being acknowledged at 31%.

The second challenge relates to how public spending is linked to economic downturns. This connection is established through budget transfers from the state to the productive sector, which is part of current expenditures. When a state-owned enterprise is unable to raise its regulated prices in response to rising costs, its demand for subsidies increases. To illustrate the significance of this spending, budget transfers to companies in 2024 doubled compared to 2023, accounting for 25% of current budget expenditures. While these transfers can be broadly interpreted as a Soft Budget Constraint issue, the existence of regulated prices makes it difficult to assess the true insolvency of businesses, as relative price distortions complicate the picture. Distinguishing between transfers aimed at keeping unviable firms afloat and those meant to prevent price increases in specific markets is challenging, if not impossible, due to the interconnection of these two issues. Therefore, progress in closing state-owned enterprises (even those known to be unproductive) should not proceed without first addressing price and market unification.

The key macroeconomic implication of the above is that, in a scenario where the price system lags, the fiscal deficit becomes endogenous, and the government loses the ability to implement traditional policies for adjusting spending and revenues. Reducing the deficit will depend, among other things, on progressively aligning state-set prices with market prices. On one hand, fiscal revenues will rise due to both the nominal and real effects of this alignment. On the other hand, cutting public spending—specifically reducing transfers to state-owned enterprises—will be feasible once these enterprises can cover their costs through their own revenue, driven by higher prices. With a new, transparently measured deficit, it will then be possible to begin spending reduction programs.