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CUBAN WARMING

THE GEOPOLITICAL CONTEXT AND FUTURE PROSPECTS IN LIGHT OF WASHINGTON'S DÉTENTE WITH CUBA

CRITICAL THINKING
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The last remnants of Cold War hostilities began to unravel on December 17, 2014 when United States President Barack Obama ordered the restoration of full diplomatic relations with Cuba and the opening of an embassy in Havana. The chasm of hostility and mistrust from the days before and since the Cuban missile crisis is being bridged, opening new avenues for greater international economic and political engagement with Cuba, as well as shining a brighter light on the potential of Latin America. This piece of good news was sorely needed in a region battered by corruption scandals, security issues and slowing growth.

Notwithstanding the President's December 17 Statement, the Cuban embargo still remains fully in effect, and its provisions must be carefully followed until such a time that Congress enacts a full relaxation of the embargo. But like other emerging markets, Cuba abounds with opportunities that are married with significant risks. Given the island government's lack of checks and balances found in democratic societies, democracy and its disregard for economic competitiveness, coupled with the traditional political risks (corruption, insecurity, infrastructure, currency, tax systems, among others) facing developing nations, investors and corporations lured by the potential demand of an untapped market should proceed with caution. This article aims to provide the geopolitical context for the current easing of U.S. sanctions against Cuba, to highlight the risks and challenges that new investors may encounter, and to offer insight in regard to the sectors most likely to provide the greatest opportunities.

Changing Tides

In order to fully understand potential opportunities, one must first understand some of the events that led up to the announcement, as well as the political and economic legacies that exist today.

Looking Back: the Caribbean and Cuba

Nearly 55 years ago, the United States declared an embargo on Cuba, effectively shutting it off from participating in the new global political economy that followed the Cold War in an attempt to weaken the island nation's Communist leadership. Since then, Cuba has relied first on massive subsidies from the former Soviet Union and later on a similar subsidy program from Venezuela. Cuba has tried to adapt to the loss of these subsidies with little success. As an island economy in the Caribbean, a region which has observed lackluster growth,[1] Cuba already suffered from limited offerings, which the U.S. had hoped would speed the process along. With a GDP comparable to the median Uzbekistan and Oman's economies,[2] Cuba is mired in stagnation and poverty. Despite its lack of efficacy, the U.S. has held onto an obsolete policy for decades and Cuba slowly stagnated. Both countries were locked in a stalemate, standing firm on their respective political and economic ideologies.

This begs the question- what has changed? It can be argued that the recent pivot stemmed from the combination of a number of factors.

Chilling U.S.-Russian Relations

Ironically, it appears that the very thing that instigated the embargo in the first place might be a factor in dismantling it; U.S. relations with Russia. At the same time that relations between the two global giants have grown to be more strained in recent years - in what many are calling Cold War II - Russian interest in its island ally has steadily increased. Following the collapse of the Soviet Union in 1991, and the essential drying up of billions of dollars of aid, Russian support had been sporadic, until Russian President Vladimir Putin took up his third term in office and began to rekindle his country's relationship with

[1] According to the IMF, the Caribbean economy as a whole is expected to expand by only 1.1 percent in 2014 and 1.7 percent in 2015.http://www.imf.org/external/pubs/ft/survey/so/2014/CAR101014C.htm

[2] http://data.worldbank.org/indicator/NY.GDP.MKTP.CD

Cuba.[3] Recently, during a surprise visit to Havana, President Putin announced the forgiveness of $32 billion dollars of Cuba's soviet-era debts (over 90%), and signed an agreement to reopen the defunct Lourdes intelligence facility south of Havana. Experts also cite Russia's interest in obtaining a berth for its fleet in the newly renovated Muriel port.[4]

Plummeting Oil Prices, the Slipping of Venezuela's Guardianship, and Energy Independence

The near 50 percent plunge in oil prices observed during the second half of 2014 has created economic and financial turbulence for several big oil-exporting nations, Russia arguably experiencing the largest of the tremors. Falling to less than $60 a barrel from around $115 a barrel in June, the drop was so steep and so sudden that it simultaneously provided a boost to the economies of the biggest oil-consuming nations (like the United States and China). While Putin hoped that Russia could weather Western sanctions over its intervention in Ukraine without serious economic impact, Venezuela's Nicolás Maduro hoped to maintain the free-spending policies of his predecessor, Hugo Chávez. Venezuela, holding one of the world's largest oil reserves, has received 95 percent of its export earnings[5] from petroleum before prices fell and it is now facing sanctions of its own from the U.S. It is having trouble paying for social projects at home, has inflation over 60 percent[6] and is the center of possible default worries in bond markets, making its access to credit even more difficult. It's largesse with neighbors is increasingly unpopular at home and has become infeasible in fact.

There is broad speculation that the price of oil played an important role in the Cuban rapprochement to Washington, as two of Cuba's strongest supporters in past years are both beset by the same malaise. Since 1999, Venezuela has sent nearly 100,000 barrels of subsidized oil products to the island daily, in addition to other economic benefits. Now, with the price of oil is at a five-year low, Venezuela's ability to continue this path is questionable, and its traditional godfather role to Cuba is estranged.

Additionally, Cuba has large offshore oil deposits of its own, which thus far have barely been tapped. Today, Cuba produces little more than 50,000 barrels per day, though estimates place the island's total offshore deposits between 124 million and 9 billion barrels.[7,8] In 2008, Cuba's state-owned oil company claimed a much more substantial estimate - approximately 20 billion barrels - which would place it among the world's top 20 producing countries.[9] In June, CUPET, Cuba's national oil company, and Rosneft, a Russian government-owned oil company, signed a memorandum in regard to the joint development of oil in surrounding waters.[10] This is only one example indicating Cuba's desire for increased energy independence. In November, the country announced its aim to generate 24 percent of its electricity from renewable resources - primarily solar, wind, and small hydropower - by 2030.[11]

Sea Infrastructure Expansion and Tacit Strategic Interests in Cuba

Another potential factor in the thawing of U.S.-Cuban relations is Cuba's strategic position within the Caribbean in light of expanding sea infrastructure. The expansion of the Panama Canal locks, planned nearly 10 years ago, has prompted numerous ports in the Caribbean and along the Eastern seaboard to revamp in preparation for the increased maritime traffic. In 2010, with financing from the Brazilian government, a subsidiary of the private Brazilian construction firm Odebrecht and the Quality Cuba SA formed a joint venture to renovate the Mariel port and construct a container terminal, set to be ready by the December 2015 due date for the expansion's completion.[12] Additionally, though facing heavy criticism, Nicaragua, with financing from the Chinese HK Nicaragua Canal Development Investment Co. Ltd., or HKND Group,

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3 http://www.wsj.com/articles/russia-writes-off-cuba-debt-1405083869

4 http://www.wsj.com/articles/russia-writes-off-cuba-debt-1405083869

5 http://www.opec.org/opec_web/en/about_us/171.htm

6 http://www.reuters.com/article/2014/12/30/venezuela-economy-idUSL1N0UD0VL20141230

7 http://www.reuters.com/article/2013/05/29/cuba-oil-idUSL2N0EA00W20130529

8 http://thinkprogress.org/climate/2014/12/21/3606048/normalized-relations-with-cuba-could-mean-more-oil/

9 http://thinkprogress.org/climate/2014/12/21/3606048/normalized-relations-with-cuba-could-mean-more-oil/

10 http://www.thewire.com/business/2014/06/cuba-hopes-to-sign-oil-deal-with-rosneft/373091/

11 http://www.telesurtv.net/english/news/Cuba-Seeks-to-Enhance-Renewable-Energy-Capabilities--20141108-0004.html

12 http://www.ipsnews.net/2014/08/cuba-sees-its-future-in-mariel-port-hand-in-hand-with-brazil/

owned by telecom entrepreneur Wang Jing, started work on the $50 billion dollar Nicaragua Canal.[13]

Industries Set to Benefit from the U.S.-Cuba Thaw

In light of Cuba's current resource base and the contextual information detailed above, what opportunities does the island present for investors? Several industries are poised to offer favorable opportunities in the short and medium term.

- **Tourism:** the tourism industry should expect to see the greatest impact in the short-term, as the number of travel categories for U.S. travelers to the island increases. While purely touristic travel will remain banned until the embargo is completely lifted, many travelers that had been previously prohibited from visiting, or forced to take less direct routes, will likely flood the island to experience the iconic Cuban lifestyle prior to any irreparable change brought on by the modern consumer markets.
- **Agriculture:** Nearly a third of the island's total landmass is highly fertile arable land, perfect for sugar, tobacco, and a wide variety of fruit crops. The normalization of relations between the U.S. and Cuba will not only allow for U.S. companies to claim prized stakes in the Cuban agricultural industry, but offer a pool of consumers for the spectrum of U.S. agricultural products.
- **Finance:** As limits on the amount of remittances inflate, and banking restrictions are eased - allowing Cuban banks to open accounts in the U.S., and U.S. financial institutions to open accounts in Cuban banks - the financial industry should expect to experience increased activity, but particularly for financial consultancy, in navigating the complexities of the new international monetary relationships.
- **Telecommunications:** As Cuba allows greater access to the Internet and other telecommunications, companies that develop and operate network infrastructure, as well as those that provide associated telecommunications products, should expect to see an explosion in demand in the near term.
- **Import/Export:** The easing of restrictions will enable U.S. companies to export specific high-demand products, such as telecommunications equipment, agricultural commodities, construction supplies and materials for small businesses, and residential goods. Additionally, opportunities may open for the U.S. import of Cuban products, particularly agricultural-related.
- **Energy:** As indicated earlier, Cuba aims to not only develop its own oil deposits, but also to incorporate solar, wind, and hydropower into its electrical portfolio. Albeit more likely in the medium to long-term, this will generate numerous opportunities for companies throughout the energy industry.

Challenges Ahead

Cuban Corruption

While foreign investment in developing countries necessarily accepts some degree of risk and uncertainty, one of the principal factors weighing on an investor's decision is the state of the political environment within a country. Ranking 63rd in Transparency International's 2014 Corruption Perceptions Index[14], Cuba is a single-party state, a system that allows for a select few to wield a great deal of decision-making power without checks, or even criticism, from an opposing party and its members. Further, there are no real checks and balances that are key to maintaining a level playing field found in mature democracies. This creates a perilous investment climate, one in which a company can easily find itself either on the wrong side of a powerful politician, or being pressured into arrangements that violate the U.S. FCPA or broader international anti-bribery laws.

Case in point: the "anti-corruption crackdown", which began in earnest in 2009 with the expulsion of more than 150 foreign business owners and operators, and over 50 individuals imprisoned by 2011, including a foreign government minister.[15] One of the business executives arrested in 2011 was Canadian citizen Cy Tokmakjian, 74, head of a transportation firm, who to this day remains in prison. Another Canadian businessman arrested at the same time, Sarkis Yacoubian, owner of an import company, apparently went on trial in 2013, and was indicted on charges of bribery, tax evasion, and "activities

[13] http://www.japantimes.co.jp/news/2014/12/30/world/doubts-over-ambitious-nicaragua-canal-project-grow-as-work-gets-underway/#.VKMkvJCcA

[14] http://www.transparency.org/country#CUB

[15] http://www.huffingtonpost.com/2011/11/19/cuba-corruption_n_1103016.html

damaging to the economy." According to an interview with journalists, he stated that "he had no choice but to pay island officials to secure business contracts."[16]

While anti-corruption efforts are typically welcome, they must be coupled with transparent intentions and appropriate due process. And typically countries where we see the most risk of fraud and corruption are also the countries that have the weakest institutions. Cuban officials presented the crackdown as a crusade to prevent the destruction of communist morals and values; critics saw it as a way for the government to seize greater control over the economy.

Impediments to Foreign Direct Investment

A related point, in terms of challenges to foreign direct investment (FDI), is the existing economic system and policies in the island nation. Currently, the process for foreign direct investment in Cuba is convoluted and lengthy. According to report on the Cuban economy and foreign investment published by Brookings in December 2012, FDI - whether in the form of joint ventures with state firms or fully foreign owned - requires formal approval by the Cuban government, in "a prolonged and multi-layered approval process" requiring numerous consultations with various agencies and institutions, as well as multiple proposal elaborations. The entire process "may drag on for two years or longer, or may languish unanswered altogether," and is far from transparent. Additionally, successful FDI ventures are "approved for a fixed time period - as low as 15 years." Therefore, potential investors face either 1) a long wait, 2) the chance their venture might not even be approved, or 3) a business window potentially too short to recoup the initial investment.

Another issue, which is less preventative to investment and more a challenge in regard to a company or firm's global reputation, is the country's currency and labor contract system. According to the Brookings report: "FDI firms are not generally allowed to directly hire labor. Rather, a state employment agency... hires, fires, settles labor disputes, establishes wage scales, and pays the wages directly to the workers. The FDI pays the wage bill to the state employment agency which in turn pays the workers." However, due to the two-currency system - one based on the U.S. dollar for the elite and tourists, and the other on the Cuban peso for everyone else - "the FDI pays wages to the employment agency in hard currency and the employment agency turns around and compensates the workers in local currency, an effective devaluation or tax of 24-to-1."[17]

Political Opposition

The most glaring challenge, however, is simply the follow-through of this Cuban warming. In the U.S., the easing of sanctions already faces vehement opposition particularly from the Republican party, (which will control both houses of Congress beginning in January[18]), and certainly from the expat Cuban community, who are expected to exert heavy lobbying pressure, but also from individuals on both sides of the aisle opposed to measures seen as enriching a government notorious for human rights abuses. Additionally, there is also staunch opposition within Cuba against increased ties with the US, from dissidents seeing the move as an act of betrayal in the struggle against the Castro dictatorship.[19]

While Obama's executive power can open the door for increased relations with Cuba, the final decision in regard to the complete lifting of sanctions lies in the hands of Congress, as the embargo was codified in 1996 as part of the Helms-Burton Act, which only Congress can change or repeal. Until that happens, investment opportunities will remain highly limited.

Cuba: Latin America's Trojan Horse

Another benefit provided by the easing of sanctions is the slow removal of the thorn in Latin America's side, whose heads of state have categorically denounced the US's stance on Cuba. The Obama Administration, which is no stranger to criticism either at home or abroad, has been chided by Latin American governments as having a lackadaisical attitude towards the region and, at times, a tentative approach[20] towards a mutual relationship of trust and respect. China has enthusiastically filled the void

[16] http://www.thestar.com/news/world/2013/05/23/canadian_businessman_goes_on_trial_in_cuban_corruption_crackdown.html

[17] Feinberg, Richard E. "The New Cuban Economy: What Roles for Foreign Investment?" *Latin American Initiative at Brookings*; December 2012.

[18] http://www.reuters.com/article/2014/12/17/us-cuba-usa-gross-idUSKBN0JV1H520141217

[19] http://www.washingtonpost.com/opinions/marc-thiessen-cuban-dissidents-blast-obamas-betrayal/2014/12/29/cc68ffcc-8f5b-11e4-ba53-a477d66580ed_story.html

[20] http://www.bbc.co.uk/news/world-latin-america-24230069

that the US seemed to apathetically leave behind by engaging in a long-term trade partnership across Central and Southern America. While there is no reason to expect that President Obama's December 17th Statement has elicited an about-face, it drew out positive reception from even the staunchest of critics in Latin America, such as Venezuela's Nicolás Maduro.[21] Clearly, embedded cynicism and distrust do not magically disappear but this rapprochement is an enormous step towards cultivating stronger and more sustainable relationships across Latin America.

Several countries across the region are poised to benefit from this change in policy. For instance, Brazil has been struggling to revitalize their ailing economy. Having also been impacted by the drop in oil prices and embroiled in a major corruption scandal with Petrobras, Brazil is feeling pressure mount on their commodity and agribusiness sectors as important export trade partners recede with slowing economies (China) and cratering currencies (Russia). Due to their involvement over the past decade, Brazilian firms have a head start in this potentially burgeoning economy.

The views expressed herein are those of the authors and may not necessarily reflect the views of FTI Consulting, Inc. or its other professionals

[21] http://www.bbc.co.uk/news/world-latin-america-30528316

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