

# The Paradigm shift of Cuban economy – A march towards development

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**Abstract-Known to be a predominantly underdeveloped economy reeling under a host of economic problems, Cuban economy is in for a major transition with new sectors growing and attracting investments. This case has a look into this transition in the economy. The case deals with the problems and the paradigm leading to a development in the economy. The case provides good insights into issues related to recession, Underdevelopment, economic reforms and cyclical shift, etc. The government is taking steps to encourage entrepreneurship and the private sector so that the economy develops. The communist party has endorsed and introduced reforms mainly to cut government payrolls and thus non-development expenditure and expand approved professions, leading to meaningful advancement in overall economic freedom. However, the state continues to interfere in most economic activity. Price controls are pervasive and the two- tiered exchange rate continues to distort prices.**

**Keywords — Economic freedom, monetary freedom, entrepreneurship, private sector growth, Reforms communism Price distortion, WTO, regulatory environment.**

## I. INTRODUCTION

Till 2013, Cuba's economic freedom score was 29.6 making its economy one of the least free economies globally. Its overall score was 0.9 point higher than 2013, resulting from slight deterioration in monetary freedom outweighed by improvements in three economic freedom criteria namely trade, fiscal and corruption. Cuba is ranked least free of the 29 countries in South and Central America/ Caribbean Region. No wonder its overall score is significantly lower than the regional average.

## II. THE SHIFT:

Quite recently, the government has made measured concessions to encourage entrepreneurship and private sector growth to put the economy on the path of development. The communist party has endorsed and introduced reforms mainly to cut government payrolls and thus non-development expenditure and expand approved professions, leading to meaningful advancement in overall economic freedom. However, the state continues to interfere in most economic activity. Price controls are pervasive and the two- tiered exchange rate continues to distort prices. Despite being a member of WTO, this communist economy remains relatively cut off from international marketplace. The communist led government in tune with its ideology encourages state enterprises to engage in international trade and investment. The regulatory environment is oppressive and works in the direction of suppressing entrepreneurial activity. The control on most means of Production is aplenty, finance / credit is slow to get, creating impediments in the way of free trade and economy expansion.

## III. THE PEEP INTO THE PAST:

A one-party Communist state, Cuba depends heavily on external assistance chiefly oil subsidies provided by

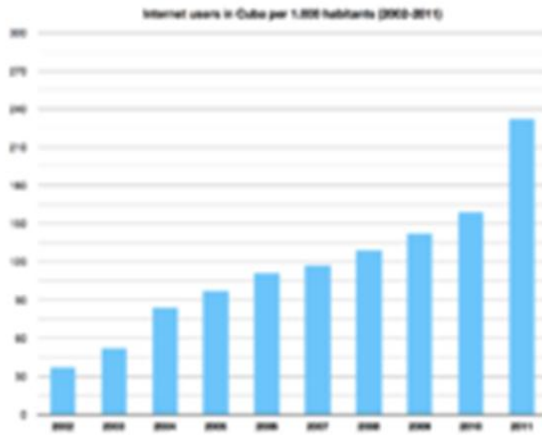
Venezuela and remittances from Cuban expatriates and a captive labour force to survive. Property right are nearly absent. Fidel Castro leads both the government and the Cuban Communist Party. Workers are not paid adequate for them to lead a decent life, the agriculture sector has been starved for investment, and revenue from tourism has been rather volatile. Under Castro one finds violent repression of civil society and the number of dissidents increasing dramatically. The much-touted "free-market reforms" have proven to be just cosmetic changes in what still remains a Socialist state. The country imposes many taxes which include a property transfer tax and a sales tax. Let us look at the economic state of the economy. Cuba's top individual income tax rate is 50 percent, and its top corporate tax rate is 30 percent overall tax burden equals 20.5 percent of domestic production. Public expenditures account for 60.2 percent of the domestic economy, and public debt is equal to about 38 percent of gross domestic product.

## IV. THE TRANSITION:

The world is seeing a major shift and transition in the economy of Cuba. This shift is because the economy has opened up quite a bit. The sectors that have been opened up include: Cuban technology, media and telecommunications sector especially to U.S. investment. This, it is presumed could benefit baseball and pre-paid cell phones. Given the political state of the economy and the prevailing civil unrest, along with government's fear of information freedom and its unwillingness to risk political instability in order to achieve the benefits of the Internet, the Cuban Economy is looking for an excuse to strike; what one experiences here will be blood, an uncomfortable sense of tension and a bad tempered, unpredictable beast, but the show must go on. One show signs of weakness or aggression, you will be attacked. If you get attacked, it will be entirely your fault, infinitely more

traumatic for Cuba and you'll never be allowed to forget it — among others

is not a newcomer to the international sports market, Santa Cruz said.



In addition to waiting for certain freedoms and flexibility that would come if the U.S. abandoned its trade embargo for Cuba, companies are waiting to see if Cuba will be able to build up its infrastructure, create workable regulations around issues such as intellectual property and deal with challenges like allocating the wireless spectrum.

#### V. OPPORTUNITIES AND CHALLENGES:

Discussing the opportunities and challenges in these industries at a panel during the recent Cuba Opportunity Summit was Enrique Martinez, president and managing director of Discovery Networks Latin America, Guillermo Santa Cruz, vice president for Mexico, Latin America and U.S. Hispanic at IMG Media, and Luis Coelho, founder and CEO of Cuba Mobile. Coelho started working in the Cuban telecommunications sector in the mid-1990s selling phone cards. He got a license from the U.S. government to do business with Cuba's state run telephone company, but faced challenges in routing calls and processing payments. With the announcement in December which said that the U.S. would resume diplomatic relations with Cuba, Coelho is now planning to launch a prepaid cell phone venture. As Guillermo Santa Cruz said "The opportunity in Cuba is: What is there that we can bring to the rest of the world?" "Long distance is not pre-pay right now; no carrier is able to bill the call," Coelho said. "They're able to post-pay, but they cannot pre-pay. "He expects the market for the first year to be about 60,000 to 80,000 customers, adding that the average customer will pay around \$60 a month. "Cuba has an expensive per-minute rate, but it's not a high margin," he noted.

President Obama's December 17 announcement prompted IMG, which packages sports content for distribution around the world, to begin talking about how its existing Cuban business would change. One needs to remember that Cuba

#### VI. THE SPORTS IMPACT:

"The international sports market in Cuba is not unique; it is part of a lot of things that are already going on," he said, noting that the Cubans participate in major world sporting events such as the Olympics and the World Cup in soccer. While baseball is "key" to the Cuban market, it's not the only thing, Santa Cruz noted.

"What we've been hearing about baseball in Cuba here is that the U.S. players are coming out of the country to play in the American in major leagues," Santa Cruz said. "But the opportunity in Cuba is: We are faced with a challenge of - What is there that we can bring to the rest of the world?" For example, the local baseball leagues in Cuba could become a draw to U.S. viewers in the way that the English Premier League is in soccer. "In the U.S., we tend to think of sports as football, baseball, basketball and hockey," Santa Cruz said. "But [around the world] we do really well with rugby, we do really well with cricket."

Broadcasting sports from Cuba is "almost like welcoming back a lost relative, Twitter" he added. "Cuba had a tournament in golf; there was Grand Prix racing in Cuba, and all of a sudden, that went away in the 1950s and 1960s."

He noted that IMG is already doing business with Cuba because the country buys the rights to broadcast the Olympics and World Cup. The Cuban government respects intellectual property rights in those arenas, but Santa Cruz pointed out that such events are put on by international federations that are often based in countries like Switzerland and, in order for Cuban teams to take part, the government needs to stay in their good graces. "How will that extend to other areas, where it's scripted content or documentaries or telecom?" he asked. Enrique Martinez adds "You have to realize, this is not going to change overnight. There needs to be an infrastructure that gets built up.

#### VII. THE START OF CUBAN CHROME:

"Is there the right environment for us to have a business in Cuba?" is a major question for Discovery Network, Martinez said. "Intellectual Property rights don't exist there right now," he noted. "Programs are transmitted on state-run television. Are they going to accept the Intellectual Property rights and rules?"

He noted that some people living on the island gain access to movies, digital versions of magazines, TV shows, music videos and websites from the U.S. and elsewhere through non state-sanctioned weekly "packets." Those who use them pay a few dollars a week to hand over their hard drives or memory sticks to distributors, who download the content onto the storage device, which people then take home and enjoy over the next week. "There is clearly an appetite for a variety of different types of content."

Discovery is currently in every country in Latin America except Cuba, and while the island is a relatively small market, "it's the last one to conquer," Martinez said. "You have to

realize, this is not going to change overnight,” he noted. “There needs to be an infrastructure that gets built up.”

The network already has three documentaries in the works that are being filmed in Cuba. Among them is a series called Cuban Chrome, which focuses on the country’s car culture, and is believed to be the first-ever American reality series filmed on the island. Martinez noted that discussions to film the series began long before the December announcement, and that it took almost a year to get the proper permits from the U.S. and Cuba. A film crew was actually on the ground in Cuba that day.

“Another project is a sanctioned collaboration between marine scientists in Cuba and the U.S. focusing on sharks,” he said. “We plan to use it for a number of different [purposes], but definitely for Shark Week.”

In the words of Luis Coelho “In the beginning [growth will come] through the satellite, because you don’t need any infrastructure on the island to do it.”

### VIII. ‘THE LAST THING YOU GIVE UP’

Currently, Internet access in Cuba is only available through one underground cable from Venezuela and via unreliable satellite links. Less than a quarter of all Cubans have access to the Internet and the island’s 90 Internet cafes often charge as much as \$4.50 a minute to get online.

“Most content is coming through satellite,” Coelho said. “In the beginning, [growth will come] through the satellite because you don’t need any infrastructure on the island to do it.”

It’s possible to bring in from the outside everything needed to broadcast a sporting event in Cuba —“it’s just how do you keep it going,” Santa Cruz pointed out. “How do you start it and keep it going in an environment where you don’t have everything you want as far as hotels, as far as sponsorship. Think about when someone brings a golf tournament to your city —where in Cuba will all that come from?”

Santa Cruz predicted that telecommunications is one sector where the government won’t entirely give up its heavy involvement. He noted that when there is a revolution in any country, the first thing that happens is the group opposing the current regime tries to take over the television stations or the newspapers. “The last thing you give up is the media,” he said. “It would follow that it will be a long road for them to give up things like spectrum.”

As the Cuban market opens up, the panellists, all three of whom are Cuban-American, expect a lot of experimentation from various groups to see what sticks. Though there are a lot of challenges to breaking into the Cuban market, Santa Cruz noted that “whether it’s romanticism or eagerness to go back to a market that was once very important, people are lining up to go back to Cuba.

With Cuba poised to open up to U.S. investment, it may be tempting for companies to jump in without testing the water. But first-mover advantage will not guarantee success —in fact, according to a group of risk management experts who spoke at the recent Cuba Opportunity Summit, it could lead

to disaster if firms do not have strong compliance programs in place.

“Like any emerging market or any new market that a company wants to go into, there’s always opportunity and there are threats for businesses,” said Glenn Ware, partner and practice group leader for anti-corruption, corporate intelligence and strategic threat management at PwC. “For example, there are labor issues, there are political issues, there are corruption risks and supply chain risks.”

Ware made his comments during an interview on the Knowledge@Wharton show on Wharton Business Radio on Sirius XM channel 111. He also moderated a panel on the topic at the Cuba summit that featured Natalia Shehadeh, chief compliance officer for Weatherford, Raj Chatterjee, chief risk officer for Tishman Speyer, and William Jacobson, a partner at the law firm, Orrick, and a former assistant chief in the fraud section at the U.S. Department of Justice. The conference was sponsored by Knowledge@Wharton, The Lauder Institute at Wharton and Momentum Event Group.

“It is people in the risk and compliance spac] who bring up the notion of first-mover disadvantage,” Chatterjee said. “You have to be deliberate and considered in making that approach. You’re worse off if you go in there, mess things up and trip over wires than if you give up a little bit of the upside ...before going in.”

### IX. THE FIRST STEP

As companies look toward a possible end to the U.S. trade embargo with Cuba, leadership needs to craft a detailed plan to enter the market. Should a firm fly solo in setting up operations? Or does it need to seek a partner already on the ground?

“Maybe there’s a business, a small business operation that’s operating from a country that’s been in for a while,” Ware noted. The entering company benefits because its venture partner has already overcome many of the obstacles to setting up shop, he added, while the other firm gains because the entering company can help it scale.

### X. SPONSORED CONTENT:

But before choosing the right counter party, firms need to look deeply at the risk profile of potential partners, the panellists opined. In addition, leadership must also have a plan in place to constantly reassess the partnership and its activities.

“Most U.S. companies don’t have an existing relationship with people on the ground in Cuba,” Chatterjee said. “So you really have to get comfortable with getting into bed with someone and not just jump at the first person out there.”

Jacobson noted that U.S. companies looking to do business with Cuba will need to thoroughly vet and employ outside contractors to aid with issues such as customs and procuring work visas —two arenas that are “rife with corruption” in many places around the world. “It’s not just the U.S. regulators you need to worry about; the multi-level development banks and their regulations have huge implications for companies,” Jacobson pointed out. “They can put them out of business entirely.”

If the embargo is dropped, the U.S. government and national and international development groups will likely encourage U.S. businesses to explore opportunities in the Cuban market — but Jacobson and Chatterjee warned that firms should not assume that this is a stamp of approval to play fast and loose with compliance. “There is no sort of immunity just because a bank or the U.S. government is pushing it,” Jacobson said.

In addition to assessing the risks of potential partners or contractors, companies should also look inward, Shehadeh said. “Companies have very short-term memories and governments often have very long-term memories,” she pointed out. “Enterprises need to assess what could be the skeletons from the past. If you did business with Cuba in the past, maybe you fled the country, maybe you left people unemployed in the country, maybe you left debts.”

A thoughtful approach to risk and compliance issues is also how a company can prove to the Cuban government that it is the kind of firm officials want operating there, Shehadeh noted. “Getting it right on entry is how you seize the competitive advantage Twitter,” she said. “There aren’t that many emerging markets left nowadays.”

## XI. RISK VS. REWARD

How much risk a company is willing to take on also affects how quickly it is able to scale in a new market like Cuba. Some companies operate in high-risk markets in a very regulatory-compliant matter and do very well, Ware pointed out. “Some of the key features of that — is there high demand? Is the product unique, such that company can insure that its counter measures, its controls, will withstand the risk demands that may be placed on them? Very valuable services that are in high demand that civil society needs can do very well in high-risk markets.”

While the Cuban market has been cut off to the U.S. for decades, a number of other countries are already doing business there. “One thing that I would ask anybody looking into going to a new market is — your competitors there, are they having success? Is there market share to be captured?” Ware said. “If the market is really saturated, that means you’re going to have to take market from a competitor. How are you going to do that?”

Jacobson pointed out that Cuban companies may not be prepared for the number of regulatory concerns and constraints that U.S. firms will bring to the table. “Think about all the countries that were able to get into the Cuban market: Russia, China and Venezuela. Those are not the countries with the best business practices,” he said. “I hate to stereotype, but we know it happens. And that’s a problem for U.S. companies that have to play by a different set of rules.”

Ware noted that while the Cuban market presents some unique challenges, there are plenty of aspects of the due diligence process that are the same no matter what country a business is trying to enter. “The part that is the same is that you’re assessing all those components,” he said. “When you’re entering a new market, obviously you know your

product. You want to know what the appetite for your product is, the demand, who the buyers are. And then you want to look at the risk lens and the threat lens.”

Also important, Ware added, is that companies have an exit strategy if things go bad. “Maybe the opportunity didn’t emerge like [a business] thought it would: Now what?”

Ware said that risk spending today is being driven not only by companies entering new markets, but also by federal regulatory laws, such as the Foreign Corrupt Practices Act. With violators now facing fines in the hundreds of millions of dollars, many leaders are highly motivated to direct their funds toward ensuring that the firm is never on the receiving end of one.

“Companies that are routinely operating in foreign markets kind of get the balance. The concern that we would have is for the new entrants,” Ware noted. “Companies that are very successful domestically realize they have to look at new markets. But they might not have the balance correct. Small- and medium-size businesses that perhaps have a great product that would work in a specific market might not have the money available to do it.”

Panelists noted that the need for risk assessment in Cuba and for markets all over the world is a constant, not something that can be addressed and abandoned the minute after a firm opens operations in a new locale. Initially, however, setting the right tone may come down to just one person.

“You’d be surprised about how it only takes one person with the right message to look your government counterpoint in the eye and say, ‘This is how we do business,’” Shehadeh noted. “It doesn’t take legions if you can get that strength of message from the person who is going to be the first boot on the ground doing the outreach.”

Cuba is a country ripe for foreign investments, but U.S. businesses must be patient with what may seem like a slow pace of change in the island nation, experts said at a recent Cuba Opportunity Summit held at the Nasdaq Market Site in New York. But for companies that take a longer-term view and invest with realistic expectations, Cuba offers a potential windfall as one of the last untapped emerging markets in the world.

For starters, U.S. businesses must discard their old view of Cuba. “Cuba in 2015 is not the Cuba of the 1950s Twitter,” said Mark Entwistle, former Canadian ambassador to Cuba and now founding partner of Acasta Capital, during a panel at the summit, which was organized by Knowledge@Wharton, Wharton’s Lauder Institute and Momentum Event Group. “It’s a much more mature country, and it’s more independent.”

While the world was taken by surprise last December when President Barack Obama and Cuban President Raul Castro announced that the two nations would work to re-establish relations, sweeping reforms have been occurring in the Communist nation for many years. The ascension of Fidel Castro’s younger brother to the presidency in 2008 was key to ushering in these changes, said Philip Peters, president of the Cuba Research Center.

“The man in charge now, President Raul Castro, is quite different from his brother, and he’s putting the country on a

path that his orthodox brother would never have chosen,” Peters said. “He’s a very blunt guy actually, very businesslike in many ways. I think he’s made a diagnosis that what they have is not sustainable and that they need to change — and he said very bluntly that either ‘we fix this or we will go under.’”

The Cuban economy has been under pressure for years, prompting the government to enact reforms that included the unprecedented mass layoff of more than one million citizens. “They couldn’t afford it anymore,” Entwistle said. These unemployed workers are being encouraged to start their own small businesses. Indeed, entrepreneurs now make up 11% of the labor force compared to 3% in 2010, Peters noted.

“These are serious changes,” Peters added. They’re based on recent realizations that “the government is too big, that the economy overall needs to be more productive, that more government projects are not the way, that they need a bigger private sector [and] they need foreign investment to drive production forward. They need a lot of it.”

This conclusion has led Cuba to initiate plans to make its market more alluring to foreign investors. In early 2014, the Cuban government passed a new foreign investment law that offered deep tax cuts, beefed up investment security and provided other benefits to investors. For instance, the new regulations would halve profit taxes to 15% and shield investors from paying it for eight years. It also axes the 25% labor tax.

The law sets out three main vehicles for investment in Cuba — commercial contracts with Cuban entities, joint ventures with Cuban partners or purely foreign-owned companies, said Gustavo Membiela, partner at the law firm of Hunton & Williams LLP. Most of the financial perks, however, would be set aside for businesses with Cuban participation or ownership. Areas prime for investment include agriculture, infrastructure, sugar, nickel mining, building renovations and real estate development, including an expansion in hotels and resorts to accompany a boom in tourism.

Disputes would be handled mostly by arbitration, bypassing the Cuban legal system, Membiela noted. In addition, businesses can choose a neutral country whose laws they want to use, such as the application of Spanish regulations, as they go into Cuba, he added. Initially, there will be various sorts of internal attempts to resolve a dispute among partners to avoid arbitration. But if that does not work, Entwistle said he knows from personal experience that the dispute would head to arbitration tribunals of the International Chamber of Commerce in Paris.

#### **XII. SPONSORED CONTENT:**

As for Cuba’s right to expropriate foreign assets, Membiela pointed out that under the new investment law, the government can only seize property under certain conditions, which are not dissimilar to the rules in other countries. Further, he noted that multilateral treaties also may protect one’s investments, depending on the place of incorporation. Cuba has multilateral treaties with 71 countries, according

to Membiela. Cuba’s ability to seize assets is a key concern for businesses following its 1960 privatization of U.S. refineries for refusing to process Soviet oil, leading to the U.S. embargo.

Besides the new investment law, Cuba has another carrot for investors. In 2013, the Cuban and Brazilian governments created the Mariel special development zone, which sits in Mariel Bay along the northern coast of Cuba, 28 miles west of Havana. The port and trade zone, which will have vastly more capacity than the port in Havana, is being touted as the Caribbean’s first container terminal facility. It can accommodate large vessels and benefit from the current expansion of the Panama Canal, according to news reports.

Mariel will provide investors with even better tax breaks and other benefits than those under the new investment law, Membiela said. For example, Mariel investors are shielded from the 12% profit tax for a decade, and all equipment and materials brought in will be treated as duty-free, according to news reports. Ana Teresa Igarza, general director of the Zone Especial de Desarrollo Mariel, told the Prensa Latina news agency that the zone has received over 300 formal requests to settle there from businesses worldwide.

#### **XIII. LOFTY GOALS:**

Cuba is aiming to attract \$2 billion to \$2.5 billion in foreign direct investments per year, which Peters said is “pretty ambitious” given that in the entire 1990s it managed to get \$4 billion to \$5 billion. But Cuba’s minister for foreign trade and investment said on state TV last year that the country needs that amount of foreign capital to achieve its economic growth target of 7% a year.

While Cuba has made drastic changes, many old ways remain that could trip up foreign investors. For instance, businesses still have to hire employees through the Cuban government, Peters noted. Also, Cuba still operates under two currencies, the Cuban peso and the Cuban convertible peso. Having a dual currency complicates transactions, bifurcates the economy and makes market pricing tougher, he added. “They need to unify the currencies and make it freely convertible.” U.S. companies also face additional barriers from a trade embargo and other sanctions levied against Cuba since 1960 that have been codified into law. These statutes will not be easy to reverse given the opposition from mostly mainly Republican lawmakers in Congress. For now, Cubans and Americans are in talks to reopen embassies in each other’s countries as the first step in normalizing relations. “The pace of all these things is kind of slow,” Peters said.

#### **XIV. A TURBULENT HISTORY**

But these changes must be viewed in light of how far Cuba has come since the middle of the 20th century. In the early years of the Cuban revolution in the 1960s, after Fidel Castro seized power from the Batista regime, the government got rid of all the foreign investors. “It was part of their achievement, as they saw it, of full ... economic sovereignty,” Peters said. The next step was to abolish private enterprise in the late 1960s. “There was a great revolutionary offensive, as they

called it, and they wiped out the remaining small businesses because they were viewed as unnecessary to the socialist project — all of them.”

The next “ideological campaign” came in 1986, when Cuba ended free market sales of agricultural produce and re-concentrated it in the hands of the state, Peters noted. The state took over the distribution of produce from farmers so there was no need for any private sector, market-based intermediary.

So what Cuba has done recently reverses its policies of the last 50 years, a drastic step whose full import should not be missed even if circumstances forced its hand. “Now all of those decisions have gone out the window,” Peters said. “These are major points in the economic history of socialist Cuba – those decisions have been reversed, and it’s a really important thing to note.”

According to Entwistle, if the Cuban economy could chug along unaided by outside investments, that would be the state’s preference. “If they could do it all themselves, they would.” But Cuba realized that if it wants to thrive, it needed outside help for such things as accessing the global capital markets. “They have realized they can’t do this by themselves,” Entwistle said. “So they are open for business on the foreign investment side.”

Internally, Cuba is also transforming itself with the creation of urban cooperatives. Entwistle pointed out that these are effectively “quasi-privatization of state enterprises.” He described them as being similar to management buyouts of state companies in a variety of sectors. Cuban economists are predicting that there could be a thousand of these cooperatives created this year. “The regulatory framework surrounding cooperatives hasn’t really caught up with where they are in the economy and in society, but it’s something to watch,” he added.

Cubans have seen an influx of foreign investments before, but it did not work out. In the 1990s, the fall the Soviet Union — its main benefactor at the time — led to a collapse of the Cuban economy. To recover, the country opened its

doors to outside investors. “There was a Wild West time from roughly 1993 to the end of the 1990s. It was crazy town,” Entwistle said. “All kinds of foreign businesses came in at that time.” While Americans were absent, Europeans, Canadians, Israelis, Mexicans and Chileans “flooded the place. They formed all these joint ventures in every rational field you could count.”

However, many of these foreign ventures failed. Cuba “learned powerful lessons in the 1990s,” Entwistle said. The Cubans realized that it was important to do their due diligence and to get to know their business partners well before entering into ventures. As a reaction to the 1990s, policy changes were made in the 2000s. The Cubans “cleaned out a lot of these joint ventures for non-performance,” he said. They included both foreign businesses as well as “mom and pop shops who couldn’t deliver.”

It is this complicated political and economic history that shapes Cuba today. U.S. companies that wish to be successful must take the time to understand this emerging market, its government and its people. “Really listen to what they tell us,” Entwistle said. “They’re hard, tough negotiators, but they’re very explicit. They’re very clear-minded. They have their own economic development priorities; it won’t be necessarily what we want to do.”

But companies that take careful consideration will find an unexpected stability in which to thrive. “Fundamentally, if you have a medium-term, strategic vision for the country, you’re not in it for a quick buck and ... you understand what you are going to do, it is in fact a very stable environment,” Entwistle said.

## XV. CONCLUSION:

Looking at the way Cuba is moving forward> It will soon become a force to reckon in global trade. One only wishes the march continues and it gets the support of its old and new trading partners