Grenada and the IMF

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Grenada: Letter of Intent and Memorandum of Economic Policies

November 2, 2009

Letter of Intent

St. George's, Grenada
November 2, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

We have made important progress with our economic program since the third review of our arrangement under the PRGF in June 2009. Addressing the impact of the protracted global economic slowdown and financial spillovers has been challenging, but we remain firmly committed to laying the groundwork for broad-based economic growth. In light of the sharp slowdown in global output growth and the continuing regional financial turmoil, we have had to update our policy framework.

The attached Supplementary Memorandum of Economic Policies (SMEP) discusses progress in implementing our PRGF-supported program, and outlines policies, objectives, and the revised macroeconomic framework going forward. We continue to give priority to mitigating the impact of the global economic slowdown and regional financial stresses, particularly on the most vulnerable groups, putting our debt on a sustainable trajectory, undertaking reforms to improve the business environment, and strengthening our capacity for economic and financial management.

We met all of our end-June 2009 quantitative performance criteria. We were able to meet the target of the primary deficit excluding grants by a margin of 0.4 percent of GDP, mainly due to significant containment of capital spending. A large revenue shortfall, tight liquidity, and some uncertainty with regard to timing of late-year external disbursements have prompted us to request a relaxation of the end-November target on domestic arrears older than 60 days. Our intention is to limit the stock of domestic arrears older than 60 days by end-November to no more than EC$25 million, and to reduce it to EC$12.5 million by end-March 2010.

The liquidation of Capital Bank remains in court. Once the court has ruled on a number of legal challenges that have been put forward by the bank's owner, and on the liquidation petition, we will move rapidly to resolve the bank through liquidation.

We have made significant progress with structural reforms. Preparations to introduce a VAT by February 2010 are solidly on track: we began the recruitment and training of VAT staff, finalized transitional procedures for bonded warehouses, and submitted the Excise Bill to parliament. We have implemented the customs Fraud Control Plan and created a separate Registrar of Companies. We expect to complete the Country Poverty Assessment later this month. We have also made substantial progress in establishing a Public Procurement Authority.

With respect to our public debt, we are firmly committed to reducing our debt-to-GDP ratio over the medium to long term. Any public borrowing we undertake, including concessional borrowing, will be closely examined for its impact on economic growth and our debt-servicing capacity. We are considering a concessional loan from the Export-Import Bank of China to build a luxury hotel in a joint venture. We are consulting closely with the IFC for an objective assessment of the economic and financial return from such a loan. In consultation with Fund staff, we would update our debt sustainability analysis (DSA) to examine the implications of such borrowing on our debt vulnerability. This loan is not accommodated under our program ceiling on bilateral concessional debt.

We intend to maintain our SDR allocation (SDR 10.2 million) in the form of reserves at the ECCB in a cooperative action with other ECCU members. We will use this allocation to build a shared cushion at the ECCB as a buffer against our high debt vulnerability, as well as financial system vulnerabilities stemming from financial stresses at home and abroad.

The attached SMEP presents our revised policy framework. Proposed quantitative performance criteria and indicative targets are indicated in Table 1, and proposed structural benchmarks are indicated in Table 2. We are committed to working to achieve these program targets. On this basis, the Government of Grenada hereby requests the completion of the fourth review under the PRGF arrangement and financing assurances review and the release of the associated disbursement in an amount equivalent to SDR 3.875 million.

The government will continue to provide the Fund with such information as the Fund may request in connection with progress in implementing the economic and financial policies. The government believes that the policies and measures set forth in our previous MEP and the attached SMEP will achieve the program's objectives. The government also stands ready to take additional policy measures as appropriate to ensure the attainment of these objectives. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEP and SMEP, in accordance with the Fund's policies on such consultations.

The government authorizes the Fund to make public the contents of this letter and the attached SMEP, as well as the accompanying staff report, to facilitate wider access to our policies and to signal the seriousness of our commitment to the program to civil society and the international community.

Yours faithfully,

________/s/_____________

Honorable V. Nazim Burke
Minister for Finance

Supplementary Memorandum of Economic Policies

1. **In the context of the global economic and financial crisis, our policy framework emphasizes four main objectives:** promoting broad-based economic growth that will benefit all members of society, strengthening the resilience of the financial sector, mitigating the impact of the crisis on the most vulnerable groups, and firmly placing public debt on a sustainable, downward trajectory. This supplement to our Memorandum of Economic Policies dated March 21, 2006 sets forth these updated economic objectives in greater detail and our plan for achieving them.

I. Recent Developments and Outlook

2. **We have revised upward our estimate of 2008 real GDP growth to 2.2 percent (previously, 0.3 percent), reflecting a stronger-than-expected performance of St. George's University.** However, economic activity slowed significantly in the first half of this year, chiefly reflecting large negative external shocks. Weak domestic demand and declining fuel and food prices have led to consumer prices falling by 2.4 percent in the 12 months to September 2009 (compared with inflation of 5.2 percent during 2008).

3. **External conditions have severely restricted balance of payments inflows.** Stayover arrivals declined by 17.8 percent for the first eight months of 2009 compared with the same period last year. Foreign direct investment (FDI) has almost dried up, with most FDI-financed tourism investment projects having been put on hold due to financing difficulties. The shortage of external financing is forcing an almost halving of the external current account deficit to 22.1 percent of GDP in 2009.

4. **Reflecting the impact of the global economic and financial crisis, particularly on tourism, real GDP is now expected to decline by 6.2 percent in 2009.** Stayover arrivals and private remittances are projected to fall sharply in 2009. FDI, which peaked at 24.8 percent of GDP in 2007, is expected to fall to 7 percent of GDP this year.

5. **Commercial banks, many of which are subsidiaries of international banks, have generally remained resilient, notwithstanding the global financial turmoil.** Growth of private sector credit and broad money slowed to 8.2 percent and -1.0 percent, respectively, at end-August 2009, reflecting weaker economic activity. The ratio of nonperforming loans (NPLs) to total loans, while still low, has deteriorated slightly, to 4.1 percent at end-June 2009, and the ratio of provisions to NPLs declined to 37.8 percent for the same period, the lowest level in recent years.

6. **The financial system remains vulnerable to contagion risks from the Trinidad and Tobago-based CL Financial Group**. ECCU governments working in tandem have appointed judicial managers to take stock of the financial situation of the British American Insurance Company (BAICO), one of two insurance subsidiaries that had been offering

deposit-like products. They are reviewing the possible formation of a new company to take over the operation of BAICO in the OECS.

II. Program Performance

7. **Reflecting our strong commitment to the PRGF-supported program, we met all of our end-June 2009 quantitative program targets.** We reduced our primary deficit excluding grants (measured below the line) to EC$43.9 million (2.5 percent of GDP), meeting the end-June target by a margin of 0.4 percent of GDP. This performance reflected less-than-budgeted capital spending resulting from sound budget control and financing constraints.

- **Capital expenditure of EC$65 million (3.7 percent of GDP) in the first half of 2009 was much less than expected at the third review (EC$90 million, 5.2 percent of GDP).** We were able to push forward with a few high-priority projects, in line with the strategy of favoring those capital spending programs that provide the greatest economic stimulus and job opportunities.

- **The central government's first half current surplus was about half a percentage point of GDP less than expected**. The shortfall reflects higher-than-expected spending on goods and services (0.4 percent of GDP) and lower-than-expected revenues (0.5 percent of GDP), partly offset by lower-than-expected interest payments (0.5 percent of GDP).

- **Notwithstanding the tight liquidity situation, domestic arrears older than 60 days remained well within the end-June 2009 target of EC$15 million.** Total expenditure arrears increased from EC$9.2 million (0.5 percent of GDP) at end-2008 to EC$30.4 million (1.8 percent of GDP) at end-June 2009, partly reflecting lower-than-expected grants (0.7 percent of GDP).

8. **We have met all but one of the structural benchmarks, in most cases with short delays.**

- Preparations to introduce a **VAT** by February 2010 are on track. We began the recruitment and training of VAT staff in May 2009 and also launched a public education program, including advisory trips to the business sector. Transitional procedures for bonded warehouses were finalized in September 2009. We submitted the new **Excise Bill** to Parliament in October 2009.

- We enacted the law establishing a new **Public Procurement Authority** (PPA) and appointed the head of this authority. Based on the recommendations of an OECD consultant, we are taking some additional time to revise this law in line with international best practice. We expect the PPA to be fully established by March 2010. We propose to rephase this benchmark to the fifth review.

- We enacted the law creating a separate **Registrar of Companies** in July 2009 and appointed the registrar to further improve the investment climate. This measure from our Action Plan to improve Doing Business Indicators will help establish a one-stop shop for new investors.

- As a result of delays in completing the technical work, the completion of the **Country Poverty Assessment** is now expected for November 2009.

- Discussions with consultants on a **customs Fraud Control Plan** have taken longer than expected, but the plan was completed in October 2009.

III. Policies for the Remainder of 2009 and 2010

9. **Notwithstanding the difficult global environment, we remain firmly committed to sound economic and fiscal management.** We are continuing to pursue fiscal consolidation in order to place the economy on a sustainable debt trajectory. Enhancing the business and investment environment is key to achieving broad-based economic growth, reducing poverty, and strengthening the resilience of our financial system.

10. **Total revenues for 2009 are projected to be substantially less than the program target, as a result of the anemic economic activity.** We were able to raise EC$16 million (0.9 percent of GDP) from the tax amnesty, EC$9 million more than anticipated at the time of the third review. However, import-related tax revenues have been particularly hard hit by the sharp decline in imports, resulting in a shortfall of EC$7.9 million (0.5 percent of GDP) in the first half of 2009.

11. **Our ability to accelerate selected capital projects has been hampered by financing constraints.** We have been able to accelerate a few Cabinet-approved high-priority projects, such as new road maintenance and debushing programs. However, significant financing constraints limited spending to about two-thirds of the expected amount.

12. **In response to the deteriorating economic environment, we have provided temporary tax relief to hotels and guest houses, with minimal fiscal consequences.** Since May 2009, half of the General Consumption Tax (GCT) has been waived, and we will extend this measure through the end of 2009 to support the tourism sector and limit job losses. We estimate that the fiscal cost in 2009 will be no more than EC$3 million (0.2 percent of GDP) because not all hotels and guest houses are participating. Owing to a lack of resources, we have allocated only EC$4 million in additional support to airlines and marketing (less than the EC$10 million originally envisaged).

13. **To achieve our fiscal objectives for the remainder of 2009 and 2010, we plan to take the following fiscal measures**:

- **Introduce a VAT,** which although technically designed to be revenue neutral, will be a broader and more efficient tax than the GCT it replaces. As a result of these efficiency gains, we expect to see a revenue boost of about 0.5 percent of GDP in 2010.

- In support of the above VAT, **introduce an excise tax** on a limited number of goods simultaneously.

- **Maintain the 4-week cycle of automatic fuel price adjustment** mechanism.

- **Further intensify tax enforcement**, following the conclusion of the tax amnesty, through garnishing of wages, seizing assets, and linking provision of government services to timely tax payments.

- **Limit the increase in wages** to less than the growth of nominal GDP over the medium term.

- **Accelerate capital spending on those priority projects** that provide the greatest economic stimulus, taking advantage of external grants and concessional loans to be disbursed later this year.

- **Improve the efficiency of spending on goods and services** and hold total spending to EC$77 million (4.5 percent of GDP). The Waste Reduction Unit in the Ministry of Finance is expected to achieve savings on fuel for government vehicles, fleet insurance, and electricity costs.

- **Target social spending** to mitigate the impact of the economic slowdown on the most vulnerable groups. We will also implement the recommendations of the United Nations and the World Bank's recent assessment of the social safety net in Grenada as well as articulate more clearly our social protection strategy in our PRSP, which we expect to complete by August 2010 (within nine months of having finalized the Country Poverty Assessment).

14. We intend to accelerate structural reforms that focus on tax and customs reform, economic management, and help lay the foundations for sustained growth and poverty reduction.

- **The customs Fraud Control Plan** will provide for risk profiles as a basis for risk-based inspections, in conjunction with the upgrade of our automated customs data program (to ASYCUDA World) beginning in November 2009.

- **Introduction of a VAT** will be a structural benchmark for the fifth review (February 2010). CARTAC is providing technical assistance on implementation, drawing on the successful experiences in other ECCU countries.

- We are developing an **Action Plan to improve Doing Business Indicators**, with World Bank technical assistance, to improve the business and investment environment. We completed two out of five identified priority areas (starting a business and trading across borders) in October 2009. We expect to complete action plans for the other three areas (paying taxes, registering property, and contract enforcement) by end-2009.

- We are continuing our efforts to establish a **Public Procurement Authority** by March 2010. We will work with the World Bank to establish bulk procurement procedures with another OECS country, and to extend the existing successful procedure with pharmaceuticals to other products such as textbooks, agricultural inputs, fleet insurance, and tires.

- We intend to implement several pieces of **public financial management legislation** enacted in 2007–08, including the Integrity in Public Life, Prevention of Corruption, Public Finance Management, and Audit Acts.

- As part of our **strategy to alleviate poverty**, and with support from the World Bank, we intend to rationalize cash-transfer programs and introduce an objective and transparent targeting mechanism. Conditional cash transfers could be used to promote human capital development among children and adults. We are also examining a reconfiguration of public works programs to protect workers from short- and long-term unemployment.

15. **In light of the severe financing constraints we are facing, we have requested increased budgetary support from multilateral donors.** We have requested an US$8 million Development Policy Loan (DPL) from the World Bank which could be disbursed in early 2010 and a US$12.8 million Policy Based Loan (PBL) from the Caribbean Development Bank, half of which could be delivered in 2009. We also hope to secure a €10 million grant from the European Union under the Vulnerability Flex facility, of which €5 million could arrive in 2009. This support, together with the requested disbursement under the PRGF arrangement, will ease adjustment to the current crisis.

16. **Notwithstanding the above efforts, in view of the sharp downward revision in projected output growth and fiscal revenues, it will not be possible to meet all of our targets for end-November 2009.** Reflecting the large revenue shortfall, a tight liquidity situation, and some uncertainty with regard to the timing of external disbursements at the end of the year, we propose to revise the end-November 2009 target for domestic arrears older than 60 days upward by EC$12.5 million (to a stock of no more than EC$25 million). We are committed to meeting the revised program target. We are also committed to taking corrective actions so that we can begin reversing the increase in domestic arrears older than 60 days as soon as possible. In particular, we brought forward to October 15, 2009, the date after which no new commitments for nonessential expenditure items can be made. Our intention is to

reduce the stock of domestic arrears older than 60 days to the original steady state target of EC$12.5 million by end-March 2010. Further revenue shortfalls could complicate this effort, for instance, if companies run down inventories in anticipation of the introduction of the VAT on February 1, 2010.

17. **We intend to maintain our SDR allocation (SDR 10.2 million) in the form of reserves at the ECCB.** We will use this allocation to build a shared cushion at the ECCB as a buffer against high debt vulnerability, as well as financial system vulnerabilities stemming from financial stresses in other ECCU countries. We also intend to limit recourse to expensive sources of financing, such as bank overdraft facilities. Notwithstanding a further deterioration in the medium-term economic growth profile (relative to the third review), we still aim to reach the 60 percent debt-to-GDP target by 2024, four years after the ECCU's 2020 benchmark for the region. We recognize that this will require substantial fiscal discipline.

18. **The government believes that the policies and measures set forth above will be sufficient to achieve our fiscal targets.** In case of further revenue shortfalls, we would undertake measures as needed to meet our fiscal targets, such as reducing current spending (including goods and services), while protecting vulnerable groups, and further rationalizing capital spending.

19. **We petitioned the High Court for the liquidation of Capital Bank in November 2008,** but the liquidation has been delayed because of challenges by the bank's owner. As soon as the court permits, we will proceed directly to liquidation. There will be no fiscal cost associated with the liquidation of Capital Bank.

20. **With respect to our public debt, we are firmly committed to reducing our debt-to-GDP ratio over the medium to long term.** Any public borrowing we undertake, including concessional borrowing, will be closely examined for its impact on economic growth and our debt-servicing capacity. We are considering a concessional loan from the Export-Import Bank of China of about US$107 million (17 percent of GDP) to build a luxury hotel in a joint venture. We are consulting closely with the IFC for an objective assessment of the economic and financial return from such a loan. In consultation with Fund staff, we would update our debt sustainability analysis (DSA) to examine the implications of such borrowing on our debt vulnerability. This loan is not accommodated under our program ceiling on bilateral concessional debt.

21. **We are continuing best efforts to extend or conclude bilateral agreements with Paris Club creditors and to seek comparable treatment from non-Paris Club creditors**. The Paris Club granted us an extension of debt relief for 2009, in line with the debt relief that the Paris Club extended in 2006–08. We will continue to seek an out-of-court settlement, through a new legal counsel in New York, with the Export-Import Bank of Taiwan Province

of China, and pursue good faith efforts to reach a collaborative agreement with Grenada's external commercial creditors that did not participate in the 2005 debt exchange.

Program Monitoring

22. **We will continue improving our capability to monitor economic developments and program performance.** A designated Ministry of Finance official, the PRGF program coordinator, will continue to oversee the monitoring of macroeconomic and structural program targets. We will continue to conduct monthly monitoring of domestic arrears and below-the-line financing of the central government overall balance. We will also work more closely with the ECCB and commercial banks to reconcile data on bank lending to the government on a monthly basis. The performance criteria for end-November 2009 are specified in Table 1 and further specified in the May 2009 Supplementary Technical Memorandum of Understanding.

IV. Other Issues

Reducing Financial Sector and Natural Disaster Vulnerabilities

23. **We continue monitoring closely the impact of developments with the troubled Trinidad and Tobago-based CL Financial Group.** Based on a financial review and feasibility study and recommendations of judicial managers of BAICO in the region, regional governments are reviewing the possibility of forming a new company to take over the operation of BAICO in the OECS. ECCU members will contribute US$10 million to a Liquidity Support Fund for BAICO to be created in cooperation with Trinidad and Tobago, Barbados, and regional and international organizations. A formula to determine country shares is still to be agreed.

24. **We are continuing our efforts to strengthen nonbank financial sector supervision.** We are reinforcing the capacity of the Grenada Authority for the Regulation of Financial Institutions (GARFIN), while continuing with the ambitious agenda of enhancing legislation, producing regulations, and developing and implementing supervisory practices (reporting, offsite and onsite monitoring) for each type of institution. The Money Services Act was passed by Parliament in May 2009 and the new Insurance Act is also expected to be passed by the end of this year, as is the Cooperative Societies Act.

25. **We will continue to participate in the World Bank's Caribbean Catastrophic Risk Insurance Facility.** The World Bank and CDB are financing the premium payments for the year beginning June 2009.

Fiscal transparency

26. **We are continuing our efforts to improve fiscal transparency**. We intend to begin disseminating to the public quarterly information (with a one-quarter lag) on the overall fiscal situation and gross financing needs by end-2009. In May 2009, we began publishing financial information on selected public enterprises. In line with the new Public Finance Management Act of 2007, we now require public enterprises to submit audited financial statements within four months after the close of the financial year. Public enterprises are also required to submit annual business plans within four months of the start of the next financial year. We will continue to publish newly granted or extended tax concessions on a quarterly basis.

Table 1. Grenada: Quantitative Performance Criteria and Indicative Targets, 2008-09

	End-Dec. 2008			2009						
				End-June			End-Sept.		End-Nov.	
	Adjusted	EBS/09/73	Corrected	Prog.	Adjusted	Actual 1/	Prog. 2/	Actual 3/	Prog.	Prop.
Performance Criteria:				(In millions of Eastern Caribbean dollars)						
Central government primary balance excluding grants (floor) 4/ 5/	-110.0	-107.5	-111.7	-52.5	-51.2	-43.9	-67.8	…	-77.9	-77.9
Stock of central government domestic arrears (ceiling)	25.0	8.4	4.4	15.0	15.0	8.6	13.5	21.0	12.5	25.0
				(In millions of U.S. dollars)						
Contracting and guaranteeing of nonconcessional external debt by the central government with maturity of at least one year (ceiling) 4/	4.0	0.0	0.0	4.0	4.0	0.0	4.0	0.0	4.0	4.0
Stock of external short term debt (ceiling) 6/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contracting and guaranteeing of bilateral concessional external debt by the central government with maturity of at least one year (ceiling) 4/ 7/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Central government or guaranteed external arrears accumulation (ceiling) 6/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Indicative Target:				(In millions of Eastern Caribbean dollars)						
Change in net credit of the banking system to the public sector (ceiling) 4/ 5/	45.0	16.9	16.9	26.9	39.2	-5.8	31.9	…	35.2	35.2

1/ The difference between the primary deficit excluding grants measured above and below the line (EC$32.3 million and EC$43.9 million respectively) is equal to the statistical discrepancy (EC$11.5 million).
2/ Indicative target.
3/ For domestic arrears over 60 days, the outturn given is for September 22, 2009.
4/ Cumulative within each calendar year.
5/ See the TMU and supplementary TMU for a description of adjustors.
6/ To be monitored on a continuous basis.
7/ Excludes PetroCaribe.

Table 2. Grenada: Structural Measures

	Target Date	Comment	Macroeconomic Criticality
Fourth Review			
Recruit and begin training staff and adopt transitional procedures for bonded warehouses	May 2009	Benchmark. Met with a delay; procedures were adopted in September	To ensure smooth implementation of the VAT
Submit new Excise Bill to Parliament	August 2009	Benchmark. Met with a delay in October	To increase the efficiency and effectiveness of revenue collection
Complete the Country Poverty Assessment	August 2009	Benchmark. Expected to be met with a delay in November	To strengthen the ability of the government to develop effective and well-targeted poverty reduction measures
Develop and begin implementing a customs Fraud Control Plan	August 2009	Benchmark. Met with a delay in October	To enhance customs administration and revenue collection for sustainable financing of the budget
Establish a Public Procurement Authority	September 2009	Benchmark. Partially met; rephased to March 2010 1/	To enhance transparency and governance in procurement and facilitate donor monitoring
Appoint a separate Registrar of Companies	October 2009	Benchmark. Met in July	To further improve the investment climate
Fifth Review			
Introduce a VAT	February 2010	Proposed Benchmark	To improve the buoyancy and efficiency of the tax system
Establish a Public Procurement Authority	March 2010	Proposed Benchmark	To enhance transparency and governance in procurement and facilitate donor monitoring

1/ A director has been appointed, but a number of other steps still need to be taken, including finalizing procurement procedures.