REPORT TO CONGRESS ON THE INTERNATIONAL MONETARY FUND'S LOAN TO GRENADA

A Report to Congress

consistent with

Section 1501 of the
Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010

United States Department of the Treasury
July 2014

Introduction and Overview

This report has been prepared consistent with section 1501 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010.*[1] The report provides an assessment of the likelihood that the recently-approved International Monetary Fund (IMF or Fund) loan made to Grenada will be repaid in full, including Grenada's debt status, vulnerabilities, and debt management strategy. Grenada's public debt is equivalent to 110 percent of its GDP (as of December 2013, the latest date for which data are available) and Grenada is not eligible for assistance from the International Development Association.

The Office of the United States Executive Director (USED) at the IMF, in close coordination with the Treasury Department, evaluates all proposals for country loans submitted to the IMF Executive Board. This includes a careful examination of a country's macroeconomic situation, debt sustainability, and the quality of the proposed policy adjustment measures to ensure a return to stability. In new programs where exceptional access is requested, the USED also takes into account IMF documentation assessing potential financial risks to the Fund. The top priority of any such evaluation is to verify that IMF resources are adequately safeguarded and that repayment risks are mitigated. The USED and Treasury staff discuss with IMF staff the key elements of such proposals in order to inform a judgment on the likelihood of repayment under the program. If repayment is in serious doubt, the USED would not support the proposal.

On June 26, 2014, the IMF Executive Board approved a three-year $21.9 million Extended Credit Facility (ECF) for Grenada. The ECF-supported program includes necessary policy adjustments and takes into account restructuring of Grenada's debt to creditors, which is under negotiation. Policy measures and financial disbursements will be spread over three years, with disbursements contingent on the Grenada government's successful implementation of agreed policy measures. **Based on aggressive fiscal consolidation measures already undertaken by the government, additional IMF disbursements contingent on meeting policy commitments, the initiation of debt restructuring discussions with creditors, Paris Club financing assurances, and the IMF's preferred creditor status, the Treasury Department and the USED assess that, while this loan poses greater financial challenges to the Fund than those normally associated with a Fund program, the prospects for repayment are strong and the loan is likely to be repaid in full. As such, the Treasury Department instructed the USED to vote in favor of the program.**

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[1]P.L. 111-203; codified at 22 U.S.C. 286tt(b), section 68(b) of the Bretton Woods Agreements Act: "Within 30 days after the Board of Executive Directors of the Fund approves a proposal [to make a loan to a country whose public debt exceeds gross domestic product and is not eligible for assistance from the International Development Association] the Secretary of the Treasury shall report in writing . . . assessing the likelihood that loans made pursuant to such proposals will be repaid in full . . . ."

Background

Grenada is a small, tourism-driven economy sensitive to the U.S. and UK business cycles and to Caribbean weather patterns. Hurricane Ivan, which struck Grenada in 2004, decimated commercial agriculture. Prior to the storm, Grenada was the world's second biggest producer of nutmeg. This crop, after being destroyed, requires seven to ten years to recover. According to certain measures, the damage caused to Grenada by the storm imposed some of the most substantial economic costs of any storm on a Caribbean island country in history. The damage created a need to finance reconstruction by taking on debt that has weighed on the country.

Grenada first restructured sovereign debt in 2005, issuing 20-year bonds to creditors, but without imposing any principal reduction and with gradually increasing coupon payments. An increase in coupon payments scheduled for 2013 in part led the government of Grenada to initiate a second debt restructuring in March 2013.

The country began to rebound before the effects of the global financial crisis undermined the tourism sector, and the economy contracted by over 10 percent from 2008 to 2012. After four years of low or negative growth, the economy of Grenada expanded by an estimated 1.5 percent in 2013. Growth was driven by the construction of a large tourist resort and increased enrollment at the country's off-shore medical school, the country's second largest employer. High unemployment remains a significant economic and social challenge. Approximately one in three workers was unemployed, according to a September 2013 survey, with youth unemployment as high as 55.6 percent.

Grenada's primary fiscal deficit increased from 2 percent of GDP in 2012 to 3.7 percent of GDP in 2013. The overall fiscal deficit rose to 7.1 percent of GDP in 2013 as coupon rates on its restructured bonds increased. The current account deficit averaged 23.8 percent of GDP from 2007 to 2012 and expanded to 27.1 percent in 2013. Initially, the current account deficit was funded by official transfers, FDI and government borrowing, though more recently it has been funded by increases in banks' foreign liabilities and external arrears.

Program Description

Grenada's IMF program seeks to restore fiscal and debt sustainability, enhance regulation and supervision of the financial sector, and improve competitiveness to stimulate private sector growth and employment. The IMF program envisages that the government's primary surplus will reach and sustain a level of 3.5 percent of GDP by 2016. The authorities have committed to implementing structural reforms aimed at improving public financial management, including limiting spending to the rate of growth of real GDP and tying the wage bill to tax revenues. Grenada has already met preconditions set by the IMF requiring it to make progress in debt restructuring discussions with its creditors and obtain Parliamentary approval for a range of revenue-generating measures. Moreover, Grenada has built a multi-stakeholder coalition to support reforms, including trade unions, private sector organizations, and civic groups.

Grenada undertook IMF programs in 2006 and 2010 with disappointing results. A review of the previous programs found that growth targets were unrealistic, the large number of structural benchmarks did not adequately take into account limits to administrative capacity, the program was not prepared to weather a variety of shocks, and the commitment of the Government of Grenada to the program was not sustained. The new program addresses these weaknesses by limiting the number of benchmarks and establishing a track record of reform during the months prior to the agreement.

Debt Status

Grenada's debt was 110 percent of GDP as of end-2013. Without the proposed fiscal adjustment and debt restructuring, the IMF projected Grenada's overall deficit to remain in the range of 8-9 percent of GDP and public debt to expand to 134 percent of GDP by 2020. If Grenada completes the fiscal adjustment but does not successfully restructure its debt, the IMF finds debt will contract to 89 percent of GDP by 2020.

Over one third of Grenada's debt is held domestically, equivalent to 37 percent of GDP, mostly by commercial banks, other financial institutions, and state-owned agencies. The largest shares of domestic debt consist of Treasury Bills (14.8 percent of GDP), restructured bonds (8.4 percent of GDP), and domestic arrears (4.1 percent of GDP). External debt, equivalent to 73 percent of GDP, is held by multilateral creditors (27 percent of GDP), the Caribbean Development Bank (15 percent of GDP), commercial creditors (24.5 percent of GDP), Paris Club members (1.3 percent of GDP), Taiwan (5.9 percent of GDP), and other bilateral creditors (6.4 percent of GDP). The proposed restructuring will include bonds restructured in 2005 with a 2025 maturity. This includes a USD 2025 bond (30 percent of debt) and an EC$ 2025 bond (11 percent of debt) issued in local markets, held by both external and domestic creditors.

Debt Management Strategy

The government's primary objective is to achieve a 60 percent debt-to-GDP ratio by 2020, in line with the Eastern Caribbean Currency Union (ECCU) debt target for its members. In order to meet this objective, the government is committed to running primary surpluses that reduce the need for additional debt and allow for a reduction in outstanding debt. In addition, the government is launching a debt restructuring process to reduce the level of indebtedness to a sustainable level over the medium term.

The authorities have a clear debt restructuring strategy in place that they have already begun to implement. The government has so far: (1) hired financial and legal advisers; (2) publicly announced its intention to seek a restructuring; (3) initiated bilateral discussions with key creditors; and (4) received financing assurances from the Paris Club creditors. Under the restructuring scenarios proposed by the government, creditors would receive between 33 and 43 cents on the dollar. The debt restructuring will not include debt owed to multilateral institutions and Treasury Bills in the regional securities market, so as to avoid contagion. Overall, Grenada will attempt to restructure 70 percent of public debt.

Vulnerabilities

Grenada's primary vulnerabilities are its exposure to downturns in the advanced economies, including the United States and UK, and natural disasters. A downturn in these economies would negatively impact tourism receipts and foreign investment inflows. Grenada's tourism industry relies more heavily on visitors from the UK in comparison to other Caribbean destinations, and was therefore more adversely affected by a recent rise in the UK's air passenger duty. Grenada is also susceptible to natural disasters, as demonstrated by the damage caused by Hurricane Ivan in 2004.

Savings gained from fiscal consolidation and revenues from the newly instituted Citizenship by Investment program, in addition to debt restructuring under the IMF program, should help to provide a cushion for the government to guard against and mitigate these external vulnerabilities.

Grenada's primary internal vulnerabilities are the exposure of its banking sector to potential cross-border contagion risks in the ECCU region. Thus far, these pressures have been contained by the regional authority's ability to provide full depositor and creditor protection. Still, a proactive strengthening of banks' balance sheets would be an important step to reduce the risk from contingent liabilities. Domestic banks are not particularly at risk as a result of the sovereign debt restructuring, as government debt held by banks subject to restructuring is only 5.3 percent of total banking assets.

Overall Assessment

Grenada is heavily indebted and vulnerable. However, its IMF-supported program, combined with the debt restructuring, provides the best opportunity for the country to return to a sustainable debt path and mitigate its vulnerabilities. IMF resources will be safeguarded by the following:

- Demonstrated commitment of the Grenada government to implement the policy measures that are a precondition of subsequent IMF financing under the program. For example, the government obtained Parliamentary approval of a range of revenue-generating measures and completed all prior actions required for program approval.

- Significant progress on debt restructuring in an open and transparent manner, with constructive government engagement with commercial and bilateral creditors.

- Financing assurances from Paris Club creditors.

- Strong IMF program conditionality and rigorous quarterly reviews to ensure continued adjustment and reform implementation by Grenada.

- The IMF's preferred creditor status, ensuring that it is repaid ahead of all other creditors.

With these factors in mind, the Treasury Department assesses that the IMF's loan to Grenada is likely to be repaid in full.