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Grenada: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

March 21, 2006

The following item is a Letter of Intent of the government of Grenada, which describes the policies that Grenada intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Grenada, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

St. George's, Grenada
March 21, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
UNITED STATES OF AMERICA

Dear Mr. de Rato:

Reconstruction activity is proceeding well following the unprecedented 200 percent of GDP damage caused by Hurricane Ivan in September 2004. Visitors to our shores cannot believe the tremendous progress that we have made in such short time, particularly in light of the additional damage and delay caused by Hurricane Emily in July 2005. This success owes much to policies that have sought to cushion the adverse impact of the hurricanes on the population, donor and creditor support, as well as the fortitude of the people of Grenada.

With reconstruction broadly on track, the government has proceeded to prepare and launch a home-grown medium-term reform programme—Enhancing Growth, Poverty Alleviation and Macroeconomic Stability. The objectives and policies the government intends to pursue during 2006–08, with particular emphasis on policies for 2006, are detailed in the attached memorandum of economic policies (MEP). The main goals of the program are to:

- Promote sustained high economic growth by improving the climate for private investment.
- Restore fiscal and debt sustainability through fiscal consolidation and reform.
- Reduce vulnerabilities by safeguarding the soundness of the financial system; and
- Reduce poverty through more effective social development programmes and safety nets.

In support of our economic policies and objectives, the Government of Grenada hereby requests a three-year arrangement under the Poverty Reduction and Growth Facility in an amount equivalent to SDR 10.53 million (90 percent of quota).

We believe that the policies and measures set forth in the attached MEP will achieve the objectives of the programme. The government also stands ready to take additional policy measures as appropriate to ensure the attainment of these objectives. The MEP reflects the objectives for poverty reduction that we outlined in our 2004 Poverty Eradication Strategy, which is being submitted to the Boards of the World Bank and IMF under separate cover as the country's Interim-Poverty Reduction Strategy Paper. Grenada will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEP, in accordance with the Fund's policies on such consultation. We expect the first review under the arrangement to be completed by September 15, 2006 and the second review by March 15, 2007. The government authorizes you to make public the contents of this letter and MEP as well as the accompanying staff report.

Yours sincerely,

____________/s/___________
Honorable Anthony Boatswain
Minister of Finance

GRENADA—MEMORANDUM OF ECONOMIC POLICIES

I. INTRODUCTION

1. **Our country is recovering from one of the most difficult periods in its recent economic history.** Grenada has been severely affected by several external shocks in recent years: the September 11, 2001 attacks in the United States which triggered a recession in 2001–02, Tropical Storm Lili in 2002, Hurricane Ivan in September 2004 (causing an unprecedented 200 percent of GDP damage), Hurricane Emily in July 2005 (which caused additional 12 percent of GDP damage), and, more recently, high world oil prices. As a result, economic growth has fluctuated sharply since 2001, and unemployment and poverty have risen. The poverty eradication and fiscal consolidation programmes that we had initiated before Hurricane Ivan struck have also been derailed. Reconstruction needs remain substantial, while fiscal imbalances, financing gaps and the public debt burden are high.

2. **The nation has nonetheless made significant strides in recent months**. Visitors to our shores cannot believe the tremendous progress that we made in such short time. Notwithstanding the additional delay and damage caused by Hurricane Emily in July 2005, there are indications that more than 60 percent of the 28,000 housing units damaged by Ivan have had some repairs done to them—though an additional 9,000 dwellings have yet to be brought on stream. And while activity in the agriculture sector remains subdued, in the tourism sector some 85 percent of the pre-Ivan capacity had been restored by end-2005. This success owes much to policies that have sought to cushion the adverse impact of the hurricanes on the population, donor and creditor support, as well as the fortitude of the people of Grenada.

3. **We have also begun to address the fiscal challenges we are facing.** Particularly in the aftermath of Ivan, the large financing gaps that emerged have been filled with all stakeholders—donors, creditors and the people of Grenada—sharing the burden:

- There has been significant international donor pledges following Hurricane Ivan. To date, US$110 million of the US$290 million that had been pledged following Hurricane Ivan has been disbursed.

- A successful debt exchange involving our commercial creditors was concluded on November 15, 2005, resulting in substantial lowering of debt service payments for the next few years.

- To contribute our share and thereby eliminate remaining financing gaps, we have taken a number of fiscal measures, including a levy on incomes to fund the reconstruction effort and a 45 percent increase in retail fuel prices.

4. **With reconstruction broadly on track, the government is now shifting its focus to addressing the longer-term economic challenges that our country faces**. Our economy needs to be revitalized. We need to once again return to the growth and stability that

prevailed before the recent shocks. To this end, in the last several months, we have been developing a comprehensive medium-term reform programme, with the help of CARTAC. The rest of this memorandum outlines key elements of this home-grown programme for 2006–08—Enhancing Growth, Poverty Alleviation and Macroeconomic Stability. The reform programme, and in particular the fiscal reform package for 2006, has benefited from input provided during the broad-based national budget consultations held in November 2005, drawing participants from the main opposition party, trade unions, business groups, as well as members of civil society.

II. Recent Developments and Outlook

5. **Economic recovery is underway:**

- With the reconstruction activity proceeding well, output is estimated to have recovered by around 1½ percent in 2005 after contracting 3 percent in the previous year. Conditions in agriculture and tourism remained weak, although activity has resumed in some areas.

- Average inflation is estimated 3½ percent for 2005, although inflation was higher at the end of the year, reflecting the recent increase in fuel prices.

- Fiscal performance in 2005 benefited from one-off factors that have boosted revenues, including from the high levels of imports of reconstruction materials, while current spending was lower than budgeted.

- Prudential indicators for the banking system showed relative stability through the first half of the year, although there was a marginal deterioration in the third quarter. Meanwhile, credit growth to the private sector recovered modestly in 2005.

- The external current account deficit is estimated to have widened sharply to about 37 percent of GDP on account of high reconstruction material imports and low tourism receipts.

6. **Growth is expected to recover in 2006 reflecting continued reconstruction activity, preparations for the hosting of the World Cricket Cup in 2007, and a pick-up in tourism.**

- Real GDP growth of 6–6½ percent is projected for 2006. Beyond 2006–07, growth of 4 percent would need to be sustained through growth-enhancing reforms.

- Average inflation for 2006 is expected to be 4½ percent, on account of the recent fuel price increase, although by year-end inflation should decline to 2 percent. Beyond 2006, inflation of 2 percent is projected.

- Fiscal measures and reforms will cover a financing gap of over 5 percent of GDP (EC$70 million) for 2006, because external grants are expected to decline and expenditure to remain high. The gaps would have increased in the outer years.

- The external current account deficit is expected to narrow in 2006 to some 33 percent of GDP. While exports are likely to remain broadly unchanged, imports are expected to decline marginally and tourism earnings to recover somewhat. The deficit is expected to be financed partly by foreign direct investment and capital grants.

III. Objectives of the Reform Programme

7. **The strategic objectives of our reform programme for 2006–08 are fourfold—sustained high economic growth, restoring fiscal and debt sustainability, reducing vulnerabilities, and alleviating poverty**. These objectives are essential for the improvement of our economic circumstances and our aspirations of higher standards for Grenadians. They also need to be advanced in tandem given the interlinkages among them. High economic growth is necessary to allow rapid poverty reduction and ease the burden of fiscal consolidation. Fiscal reform, in turn, is required to ensure that public debt sustainability is achieved in an orderly manner and maintained, fiscal imbalances do not become a drag on growth, and to help pay for initiatives to alleviate poverty. Reducing vulnerabilities, including by safeguarding the soundness of the financial sector, is essential to ensure the durability of growth. Finally, alleviating poverty is the imperative that motivates our social development agenda.

Sustained high economic growth

8. **As our Poverty Eradication Strategy highlights, improving the standard of living of our citizens is the overriding objective of government's economic policies.** This in turn requires sustained high economic growth (at least 4 percent), with the private sector playing a more vibrant role than in the past. To this end, the near-term focus of our structural reforms will be to put in place a policy environment that is much more conducive to private investment. This will include steps to ensure that Grenada Industrial Development Corporation (GIDC), our investment promotion agency, starts to play a more prominent and proactive role in promoting the country as an attractive investment destination, improving the manner in which land can be acquired by investors, as well as comprehensive reforms to improve the tax system's transparency and predictability. The planned Public Sector Modernization Project will also serve to make the rest of the public sector more efficient, customer oriented and productive. Reforms in the second and third years of our programme will focus on measures to enhance labor and product market flexibility, respectively.

Restoring fiscal and debt sustainability

9. **We recognize that, in the absence of reforms, Grenada's fiscal and public debt situation is unsustainable**. The public debt stock is very high at 130 percent of GDP—or some EC$15,000 for each Grenadian. Without fiscal consolidation, by about 2010, virtually

all of the tax revenues that the government collects would be spent on civil service salaries and interest payments, leaving little room for outlays on goods and services or transfer to households, much less capital investment.

10. **Accordingly, an important element of our reform programme is to restore debt and fiscal balances**. We have designed and phased our fiscal programme so that it will sustain the current economic recovery. In particular, the programme will facilitate the capital investment required in 2006 and 2007 to ensure that the ongoing reconstruction effort and preparations for the 2007 Cricket World Cup can be completed successfully. At the same time, with the adoption of a number of important revenue and expenditure measures, the fiscal reform package will allow the fiscal accounts to swing gradually from an underlying primary deficit of 2 percent in 2005 to a primary surplus of 2.5 percent of GDP in 2008. Providing the surplus is kept at this level thereafter, our public debt will decline sharply to the more prudent—although still high—level of 60 percent of GDP by around 2015.

Reducing vulnerabilities

11. **The durability of the current recovery also depends on attenuating vulnerabilities to natural disasters and safeguarding the soundness of the financial sector.** Grenada has traditionally been considered to be outside the hurricane belt. But recent events suggest that this may no longer be the case, and accordingly our preparedness for extreme weather events needs to be strengthened considerably. To this end, our programme aims to improving adherence to the building code and encouraging citizens to acquire insurance. Our reform programme also aims to address other sources of vulnerability for our economy, including by safeguarding the soundness of the financial sector.

Reducing poverty

12. **Social development, particularly by alleviating poverty, is the other important programme objective**. Social conditions have deteriorated in the aftermath of Hurricane Ivan. The unemployment rate stood at 19 percent in July, and was especially high among women (more than 25 percent) and youth (more than 30 percent). While data collection on social indicators needs strengthening, preliminary indications are that the poverty rate is likely to have risen. To reverse these trends and guide our social development agenda in the coming years, we will start preparing in the coming months a comprehensive poverty reduction strategy paper (PRSP), which will update and expand the Poverty Eradication Strategy prepared in 2004. The 2006 budget will also focus on introducing social safety nets for the poor and vulnerable of our society, particularly those worst hit by the increase in domestic fuel prices to world market levels in October.

IV. FOSTERING ECONOMIC GROWTH

13. **To promote private sector activity and achieve high economic growth rates and better employment prospects over the medium term, our reform programme envisages several measures to improve the investment climate**. Higher private investment is critical

to sustain growth beyond 2007, once the positive effects on output from the ongoing reconstruction activity and hosting of the 2007 Cricket World Cup subside. The economy has, traditionally, been well diversified, and we want to maintain this feature of our economy. To this end, increased investment in and a recovery of, in particular tourism and agriculture, is needed.

14. **To address these challenges and improve the investment climate, the following measures are envisaged for 2006**. These measures will complement intended reforms to the tax incentives regime and our continued commitment to ensuring the soundness of the financial sector (see below):

- ***Strengthening investment promotion***. We intend to review the role of Grenada Industrial Development Corporation (GIDC) with a view to improving its effectiveness in promoting new investment. Over the years, GIDC's focus has shifted to one of screening requests for tax incentives, reflecting the limited resources available to the agency as well as the high administrative cost associated with the current tax incentive system. But with the planned simplification and rationalization of the tax incentive regime (see below), GIDC should be able to focus on its core mandate: promoting Grenada as a favorable investment destination, including in the tourism sector. This should include steps to turn GIDC into a one-stop shop for investors. In a similar vein, the due diligence process for new investments will be strengthened, so as to allow for better assessments of the viability of projects.

- ***Investment code***. The government is in the process of preparing a new investment code to be legislated by September 2006. This code will, inter alia: improve and clarify the legal system for investment in Grenada; outline investor rights and obligations; detail investment procedures; and the means to access fiscal incentives.

- ***Facilitating land transactions***. To facilitate private investment and improve the efficiency of land use, the following initiatives are planned:

    - A project has been initiated to upgrade the land registry with a view to enhancing the accessibility of the records therein to the public, including with respect to information on leaseholds of public lands granted by our government, the duration of these leaseholds, and to whom they have been granted. This project will be completed by end-2006.

    - Second, a new executive agency to manage issues related to land use will be established by end-2006, pulling together the valuation section of the Ministry of Finance, the land and surveys division of the Ministry of Agriculture and the Registry at the Supreme Court.

    - Third, all significant future divestments of public properties will take place through well advertised international auctions, so as to attract the widest possible range of investors and enhance transparency.

- ***Simplifying customs clearance.*** The envisaged reforms at the Customs Authority (see below), will seek to reduce the amount of paper work and time (currently as much as four days) needed to clear imports through the ports.

- ***Implementing export strategy***. We have recently initiated preparations for a National Export Strategy (NES). This initiative, which is being carried out in close partnership with private sector stakeholders and NGOs, seeks to support and promote existing and potential export sectors through a comprehensive and consistent set of policies. These policies pertain in particular to the general business environment, training, trade liberalization, trade promotion, the reduction of transaction costs (including through customs reform), and the institutional strengthening of the "trade support network" that comprises various relevant public and private sector bodies. The strategy will also seek to exploit possibilities for the creation of support industries around specific clusters of activity—in particular around tourism. We will seek to complete the NES by mid-2006.

15. **Beyond the measures slated for 2006, our reform program envisages action in several other areas over the next three years**. In particular, to enhance labor market efficiency and flexibility, we will launch a review to assess the effectiveness of the market. Measures are also envisaged to tap the large expatriate community of our country, including in the areas of skills development and training, investments (especially in entrepreneurship and small businesses) and finance. Furthermore, to foster the functioning of markets and efficient allocation of productive resources, we plan to abolish most of the small number of price controls except on a few essential items. And finally, we will explore the role of the financial sector in enhancing small business development.

V. Restoring Debt and Fiscal Sustainability

16. **The fiscal measures we have undertaken over the past year, coupled with reforms discussed below, will help restore debt and fiscal sustainability.** A critical mass of these measures have been undertaken in the context of the 2006 budget and early in the programme period. The fiscal programme is also consistent with the goals of improving the structure and efficiency of public finances; reducing poverty, including to achieve the Millennium Development Goals; and enhancing the investment climate. It comprises revenue and expenditure measures, structural reforms, and a debt strategy.

A. Fiscal Measures

Revenues

17. **In light of the need for additional revenues to finance the reconstruction effort, we have introduced a national reconstruction levy on wages and salaries for a period of three to five years.** The levy has been approved by Parliament, and collections will commence on income earned starting on January 1, 2006. The levy is 5 percent (3 percent during January 1 to June 30, 2006) for those earning salaries of EC$1,001–5,000 per month, EC$225 per month for those earning between EC$5,001 and EC$9,000 per month, and

EC$350 per month for those earning above EC$9,000 per month. While the levy entails an additional burden on the population, it is necessitated by the large financing gaps the government faces. The design of the levy takes into account the fact that personal incomes below EC$5,000 per month are exempt from income taxes. To ensure that the levy is collected promptly and efficiently, we have provided additional resources to the Inland Revenue Department (IRD) and put in place a software module that will help with the management of the levy. Our aim is to collect EC$10.5 million per year, about ¾ percent of GDP.

18. **Having kept domestic petroleum prices unchanged for sometime to ease the burden on the public following Hurricane Ivan, we adjusted domestic prices in October to reflect developments in world market prices, and will introduce an automatic fuel price mechanism shortly**. We raised domestic fuel prices by over 45 percent on October 1, 2005, which has helped to eliminate the subsidy that resulted in the build-up of about 2 percent of GDP in liabilities to the oil importing companies. We are now in the process of introducing a transparent, automatic fuel pricing mechanism which includes a total tax element of at least EC$2 per gallon. This measure could generate EC$16–20 million per year. To mitigate the adverse effect of the recent price adjustment on vulnerable groups, we are putting in place social safety nets (see below). To facilitate transparency, we have cleared all outstanding obligations to one of the oil importing companies, and reached agreement on a repayment schedule with the other company. The outstanding liabilities have also been added to our debt stock.

19. In addition, we will undertake administrative improvements, collect on tax arrears, and revise property valuations.

- *Improving tax administration.* We will seek further technical and financial assistance to strengthen administration at the Customs and Excise Department, including possibly by hiring specialized private firms with experience in helping other countries improve customs revenue collections procedures. We will also seek assistance in strengthening the audit capacity at Customs and in the Inland Revenue Department, and tightening enforcement, including by introducing systems to enhance information exchange between the departments. We plan to commence formulating and implementing reforms in these areas in the second half of 2006.

- *Nontax revenues.* The project planned to upgrade the land registry should help to boost the collection of fees and arrears related to leaseholds. Plans are also underway to improve collection of company registration fees by end-2006, and we are in the process of examining the need to adjust other fees and charges that have remained unchanged for long periods. These initiatives will be complemented by administrative steps that we are taking to improve the collection of nontax revenues.

- *Property taxes.* Property taxes on buildings are paid on values as at 1994. Consequently, work needs to commence on a comprehensive cadastre that will allow us to revalue all land and property to reflect current market values. We will also examine the possibility of making legislative changes to allow the Inland Revenue Department greater leeway in using alternatives to property-by-property inspections in determining the value of these assets.

Spending reform

20. **In light of the destruction and suffering caused by Hurricane Ivan, compressing public wages is not an option and accordingly the programme will try and protect real wages**. To this end, we will seek early agreement with the civil service unions on the wage path for 2006–08 in line with the projected evolution of average annual inflation, following discussions in the context of the multipartite committee that has been established. Provided growth accelerates, the wage-to-GDP ratio should decline, helping reverse the recent rapid increase in the wage bill (by about 35 percent in the last five years).

21. **We will also strengthen PSIP planning and implementation so as to undertake only projects with high social and economic rates of return.** We will seek the assistance of the international donor community, specifically the Caribbean Development Bank and the World Bank, to screen all projects above EC$5 million. This will result in a streamlined and effective capital expenditure programme to meet the needs of the economy. Moreover, the PSIP would be made consistent with the objectives for poverty reducing to be laid-out in the forthcoming poverty reduction strategy paper. Once the reconstruction and the World Cup Cricket related projects are completed, the capital budget would decline to about EC$130 million, or 8 percent of GDP, by 2008. A higher capital budget will depend on higher grants and concessional financing being available.

22. **We are undertaking additional measures to control and lower expenditures.** These include:

- *Goods and services spending*: subjecting government procurement to competitive bidding, including for outsourced services. With assistance from the World Bank, we will strengthen procedures for monitoring and reviewing contracted services to ensure that they are delivered as contracted. Together with further control on other spending, potential savings are expected to be about ½ percent of GDP by 2008.

- *Transfers and subsidies:* in light of the dislocation that the sharp increase in oil prices is likely to have caused, we have made provision for well-targeted social safety nets for the elderly poor and needy students of about EC$5 million in the 2006 budget.

23. **In sum, by implementing the above measures, we have targeted about one-quarter of the underlying medium-term fiscal consolidation in the 2006 budget.** On the revenue side, the national reconstruction levy will generate around ¾ percentage points of GDP per annum. Expenditure savings would come from keeping wage increases constant in real terms. A primary deficit (excluding grants) of EC$110 million (7¾ percent of GDP) is targeted under the 2006 programme. Consistent with this, we will avoid supplementary budgets (or special warrants) that will increase spending without matching tax revenues and/or higher grants.

B. Fiscal Reforms

24. **To improve the structure and efficiency of public finances as well as to facilitate growth enhancing reforms, our programme includes comprehensive tax and civil service reform**. Widespread use of inefficient tax concession instruments has resulted in a substantial erosion of the tax base. Civil service reform is also needed to allow decompression of the wage scale and reward performance and to improve the quality and efficiency of government services. Beyond this, we will improve fiscal transparency and reporting, including for statutory bodies.

Tax reform

25. **We will introduce a value-added tax (VAT) by January 1, 2008.** Work on this had commenced before Hurricane Ivan struck, and this now needs to be revived. The VAT will replace the existing consumption tax that applies on a relatively narrow base and has multiple and varying rates for domestic and imported goods. To broaden the base, the VAT will only incorporate standard exemptions (financial, education, and health services, etc.) with a zero rate for exports and a single non-zero rate for all other goods and services. The VAT and accompanying system of excises will be calibrated to be broadly revenue neutral.

26. **The government has initiated reforms to the current costly and complex system of tax incentives.** During 2000–02, revenue forgone from import duty and consumption tax concessions was nearly 11 percent of GDP. In 2003–04, we took steps to curtail concessions, although these efforts were set back by Hurricane Ivan. Going forward, we will publish all new concessions granted on a quarterly basis starting in June 2006, with information on the beneficiaries of tax concessions, their intended purpose, and the cost of the concessions in terms of revenue foregone. Specific reforms in this area will include:

- **Income tax.** Effective January 1, 2006, the government will not grant any new tax holidays or renew expiring ones; incentives thereafter will be provided in the form of tax write-offs for investment and after June 30, 2006 through accelerated depreciation with loss carry forward provisions. We will discontinue the granting of tax holidays because they are an inefficient tool to promote higher investment, provide incentives for investors with short horizons, and continue to bestow tax relief irrespective of whether further new investments are made. In contrast, a system that relies on accelerated depreciation has the benefit of providing tax relief for those undertaking new investments. Moreover, such reforms are consistent with the new CARICOM guidelines on tax incentives. Accordingly, we will submit to Parliament amendments to the Income Tax Act by end-April to allow us to adopt a system of accelerated depreciation and five-year loss carry forward for investments. There will be no renewal of existing holidays, although holidays currently in effect will be grandfathered. Until the legislative amendments are put in place, tax incentives, where warranted, will be granted in the form of tax write-offs, as has been the practice in most instances in the last few months.

- **Consumption tax.** Reforms to concessions on consumption taxes will occur in the context of VAT introduction by January 1, 2008. All consumption taxes will be repealed and replaced with a broad-based VAT with a low rate and few exemptions. Until the introduction of the VAT, we will not renew expiring consumption tax concessions.

- **Import duties.** We will also initiate a review on options for reform of the import duty regime for completion by end-September 2006. This review will, inter alia, consider the need to provide import duty exemptions for exporters, including in the tourism sector. The objective of the review will be to reduce the scope of exemptions currently provided for in SRO/37/99.

- **We will also repeal the Investment Code Incentives and Qualified Enterprises Acts by end-June, 2006**. These little used acts will not be necessary once the new incentive regime for income taxes is put in place, and will accordingly be repealed.

27. **Beyond this, provided the revenue situation permits, we will announce a firm timetable to lower the corporate income tax in a gradual manner to promote higher private investment.** One possibility would be to lower the tax rate gradually to 25 percent over the 2007–10 period. Across the region, there has been a move towards lower corporate tax rates to encourage new business creation and expansion of existing businesses. A reduction in the rate from 30 percent to 25 percent would cost about EC$5 million per year. The tax cut would benefit small-and medium-scale enterprises and promote economic diversification.

Civil service reform

28. **We are undertaking reforms to enhance the performance appraisal system in the civil service and improve the efficiency and quality of government services, including through commercialization.** With assistance from the World Bank, we are undertaking a Public Sector Modernization Programme that will be implemented during 2006–10. We have maintained a freeze on public sector positions since 2000, although reforms are needed, given considerable outsourcing of government services in the interim. The civil service reform programme that we plan to undertake in 2007 will, inter alia, examine the need for greater flexibility in employment and separation decisions, decompression of the wage scale to reward (and retain) high performers, as well as the need to rebalance the civil service mix towards more professional and fewer clerical staff.

Fiscal transparency and institution building

29. **Improving the transparency of public finances and strengthening fiscal monitoring are important goals of our reform programme.** To this end, we will implement the following measures:

- Every quarter, we will disseminate information publicly on the overall fiscal and economic situation, possibly through press briefings or presentations in Parliament and on the government's official website.

- We will strengthen budget accountability by making the Audit Department fully operational and enforcing regular auditing procedures.

- All expenditures will be reported on the budget, including the expenditures of the Grenada Reconstruction and Development Fund and transfers to the Agency for Reconstruction and Development.

- The budget formulation will include quarterly projections of gross financing needs as well as targets and performance indicators.

- The formulation of the PSIP and reporting by line ministries of capital spending will be improved by establishing monthly reporting of capital expenditures.

- We will require public enterprises to submit audited financial statements at the close of the financial year, as stipulated by law. To facilitate close monitoring of developments in their financial accounts, we will establish a mechanism in 2006 for quarterly reporting (with a one-quarter lag), which would serve as an early warning system. The financial conditions of these entities will be reviewed and financial management guidelines will be prepared.

C. Debt Strategy and Privatization

30. **Our government's debt exchange offer has been a resounding success**. Holders of over 90 percent of eligible claims participated in the exchange, providing substantial and necessary near-term cash flow relief. We will make good faith efforts to dialogue constructively with those creditors with eligible claims that did not participate in the exchange. Wherever possible, we will reach out to them.

31. **We also intend to intensify our dialogue with official creditors and request debt relief on terms comparable to those provided under the debt exchange offer.** In keeping with best international practices, we are committed to the principle of inter-creditor equity. After seeking Fund support for our programme, we will approach our Paris Club and non-Paris Club creditors for relief.

32. **We are undertaking steps to enhance our debt management capacity and transparency.** With assistance from the Commonwealth Secretariat and the ECCB, we are upgrading the debt recording systems. We will develop further and implement a debt management strategy with a view to improving the debt profile and lowering vulnerabilities, including through retiring expensive debt with any financing surpluses that accrue and asset sales.

33. **We are considering divesting remaining government assets and using the proceeds to retire debt and to finance approved capital expenditures subject to strict rate of return analysis**. While most of the privatization and divestiture occurred in the 1990s, our government retains small share holdings. We are also in the process of acquiring assets related to government guarantees that were called. Sales of the assets will be conducted through a transparent bidding process. The proceeds from the sale will be used to reduce the high level of public debt. We will consider carefully the timing of the asset sales. While early sale of some assets is desirable to avoid damage to partially completed tourism projects to which some of the guarantees pertain, sales of too many assets at the same time could signal distress sales and depress prices.

VI. Reducing Vulnerabilities

34. To safeguard the soundness of the financial system, our government will:

- **Request the ECCB to undertake an on-site inspection of the banking system before end-2006**. Aggregate prudential indicators show that commercial banks are generally in good shape, with adequate capitalization and loan-loss provisioning. Nonetheless, the damage to housing stock as well as slowdown in economic activity caused by Hurricane Ivan may have placed bank balance sheets under stress, and an on-site inspection will be important to ensure that banks remain adequately capitalized going forward.

- **Enact the Grenada Authority for the Regulation of Financial Institutions (GARFIN) legislation.** To strengthen the supervision of the banking sector, we have passed a new Uniform Banking Act in August, making us one of the first countries in the region to do so. Our banks are now supervised under this new Act. To strengthen the supervision of the nonbank financial sector that includes the insurance sector, cooperatives, the offshore sector and money changers, we will introduce the GARFIN Act in Parliament in January next year, with a view to having it enacted by March. The Act would establish a single supervisory agency for the nonbank financial sector. Furthermore, we intend to increase staff resources devoted to supervising the sector.

35. **The durability of the current economic recovery also depends on our ability to diminish the impact of natural disasters**. To this end, we intend to:

- ***Enforce the building code***. We will consider whether this code should be given the force of law. Its enforcement will also be stepped-up.

- ***Strengthen the regulation of the insurance sector***. Enactment of the new Insurance Act will help ensure contract certainty, improve confidence in the sector, and better protect policyholders.

- **Participate in regional initiatives**. We will actively look to participate in the World Bank's Catastrophic Risk Insurance Project, which is designed to pool insurance risk across the countries.

VII. Social Development

36. **We are in the process of prioritizing our social development agenda, building on the extensive work that was done in recent years.** A Poverty Eradication Strategy was prepared in 2004, and more recently we have undertaken a Core Welfare Indicator Questionnaire as well as a Macro-Socio-Economic Assessment of Damage by Hurricanes Ivan and Emily. These initiatives are in addition to the many programmes already included in the 2006 budget to further social development, such as the support to farmers and construction of low-income housing units. Building on all of these initiatives, we will rely on an updated version of the 2004 Poverty Eradication Strategy as our Interim Poverty Reduction Strategy Paper (PRSP). And a full-fledged PRSP will be elaborated in 2006 through a broad consultative process. This document will aim at sharpening the focus and coherence of the poverty reduction initiatives, ensuring that scarce resources are better directed to the neediest members of society. In addition, it will link the poverty reduction objectives closely to the social development programmes in the budget, while ensuring consistency with the overall macroeconomic and fiscal objectives. More specifically, the PRSP will:

- *Adopt a forward-looking and strategic approach***,** clearly defining the goals for poverty reduction and spelling out steps needed to achieve our poverty reduction objectives, including the Millennium Development Goals (MDGs).

- *Evaluate the effectiveness of existing poverty alleviation programmes*, with a view to making better use of empirical evidence to assess programme effectiveness. In addition, it will define which institution or agency is responsible for assisting in achieving which objective; the size, financing, and duration of programmes; and the modes and timeframe of implementation.

- *Prioritize programmes and policies according to their desirability and social effectiveness*. Detailed costing—separating investment outlays from expected recurrent costs for future maintenance and operation—will be made part of the cost-benefit analysis, to facilitate the evaluation of consistency with the fiscal objectives of the macroeconomic framework, the PSIP, and available domestic and external resources.

37. **In the 2006 budget, we plan to put in place a social safety net to help the most vulnerable segments of society cope with new challenges**. Long-term social development efforts need to be supplemented by targeted social safety net measures: (i) to ensure that progress in poverty reduction is not rolled back by the effects of the hurricanes; and (ii) to protect the most vulnerable segments of the population from the side-effects of policy actions such as retail fuel price increases. In this vein, the 2006 budget will include:

- An increase in the monthly transfer to needy elderly persons, mainly in rural areas, from EC$100 to EC$135 at a budgeted annual cost of about EC$4 million; and

- A scheme to temporarily subsidize the increase in bus fares for about 2,000 tertiary students at a budgeted annual cost of EC$1–1.5 million is also being considered. Given the seemingly permanent nature of the increase in international oil prices, this subsidy will be phased out over time.

Table 1. Grenada: Structural Benchmarks for 2006

	Category	Target Date
Fiscal reforms		
Reach agreement on public service wage path for 2006–08	Benchmark	End-April 2006
Initiate comprehensive reforms to Customs administration	Benchmark	End August 2006
Initiate work to strengthen PSIP planning and implementation by seeking CDB and/or World Bank assistance in screening projects above a threshold (EC$5 million)	Benchmark	End June 2006
Publish information on all new concessions granted from January 1, 2006		End-June 2006
Stop granting new tax holidays or extending holidays		January 1, 2006
Amend Income Tax Act to adopt a system of accelerated depreciation and five-year loss carry forward	Benchmark	End June 2006
Repeal Investment Code Incentives Act, Qualified Enterprises Act, and tax components in all other incentives legislation including Hotel Aids Act and Fiscal Incentives Act	Benchmark	End June 2006

Table 2. Grenada: Quantitative Performance Criteria (PC) and Indicative Targets (IT) for 2006

	31-Mar (IT)	30-Jun (PC)	30-Sep (IT)	31-Dec (PC)
Performance Criteria:				
(In millions of EC$)				
Central government primary balance excluding grants (floor) 1/2/	-40	-60	-90	-110
Stock of central government domestic arrears (ceiling) 3/	22	22	22	22
(In millions of US$)				
Contracting and guaranteeing of nonconsessional external debt by the central government with maturity of at least one year (ceiling) 1/	16	16	16	16
Stock of external short-term debt (ceiling) 3/	0	0	0	0
Central government or guaranteed external arrears accumulation (ceiling) 3/	0	0	0	0
Indicative Target:				
(In millions of EC$)				
Change in net credit of the banking system to the public sector (ceiling) 1/ 4/	0	0	0	-33.5

1/ Cumulative.

2/ Floor will be adjusted downward to the extent grants exceed programmed amounts; and adjusted upward for shortfalls in grants exceeding EC$25 million.

3/ To be monitored on a continuous basis.

4/ Ceiling will be adjusted upward to the extent that grants fall short of programmed amounts up to a limit of EC$25 million.

Grenada: Technical Memorandum of Understanding

1. Grenada's performance under the Poverty Reduction and Growth Facility (PRGF), described in the letter of the Government of Grenada dated March 21, 2006, will be assessed on the basis of the observance of quantitative performance criteria as well as compliance with structural performance criteria and benchmarks. This Technical Memorandum of Understanding (TMU) defines how the quantitative performance criteria and indicative targets, specified in Table 2 of the Memorandum of Economic Policies (MEP), will be interpreted. It also lays down the monitoring and reporting requirements. The Grenadian authorities are committed to continue transmitting to the Fund staff the best data available and any revisions thereof.

2. The variables mentioned herein for the purpose of monitoring the performance criteria, which are not explicitly defined, are consistent with the Government Financial Statistics (GFS). For variables omitted from the TMU which are relevant for the program targets, the authorities of Grenada shall consult with the Fund staff on their appropriate treatment, based on GFS principles and Fund program practices.

I. General Definitions

3. For the purpose of the program, **central government** will cover all items included in the government budget, including transfers to the Agency for Reconstruction and Development.

4. The **nonfinancial public sector** is defined as the total of the central government and nonfinancial public enterprises. In addition to the Agency for Reconstruction and Development, public enterprises include: Grenada Ports Authority; Grenada Airport Authority; National Water and Sewerage Authority; Housing Authority of Grenada; Grenada Industrial Development Corporation; Grenada Solid Waste Management Authority; Gravel, Concrete and Emulsion Production Corporation; Market and National Importing Board; Grenada Postal Corporation; Grenada Board of Tourism; Grenada Bureau of Standards; Grenada Cultural Foundation; Grenada Craft Center; Grenada Commercial Fisheries Company; Grenada National Lottery Authority; Grenada National Stadium Authority; Grenada Food and Nutrition Council; National Telecommunications Regulatory Commission; and Grenada International Financial Services Authority.[1] Any new nonfinancial public enterprises that are established during the program period will normally also be covered under this definition.

[1] Excluded are the Banana, Cocoa, and Nutmeg Associations and the Minor Spices Co-operative Society as these are cooperative entities owned largely by private sector shareholders.

5. **External debt** is defined as all debt owed to creditors residing outside of Grenada, while **domestic debt** covers all debt owed to residents of Grenada. For ease of monitoring, all bonds issued at the Regional Government Securities Market (RGSM) will be regarded domestic debt.

II. Performance Criterion on the Primary Balance of the Central Government Excluding Grants

6. The **central government primary balance excluding grants** will cover the activities specified in the budget and is derived as shown in Table 1 below. Revenues will not include any proceeds from the sale of public assets exceeding EC$1 million, which will be considered as financing, below the line. Expenditure will include transfers to public enterprises.

Table 1. Performance Criterion on the Primary Balance before Grants

Revenues	a
Grants	b
Current primary expenditure	c
Capital expenditure	d
Interest payments	e
Primary Balance before Grants	**a - c - d**
Overall balance	a + b - c - d - e

7. The central government primary balance will be measured from the financing side as the sum of the net domestic financing plus net external financing plus domestic and external interest payments on a due basis minus grants.

8. **Net domestic financing** of the central government is the sum of:

(i) net domestic bank financing as measured by the change in the domestic banking system credit to the central government net of deposits, as reported by the consolidated balance sheet of the monetary authorities[2] and commercial banks, including special tranches from the ECCB;

(ii) net nonbank financing as measured by the net changes in holdings of government securities by nonbanks, and net borrowing from nonbank institutions;

[2] Consolidating the ECCB's balance sheet (excluding the government's IMF operating account) and the government's transactions with the IMF.

(iii) the change in the stock of domestic arrears of the central government defined as net changes in unpaid checks issued, unprocessed claims, pending invoices, plus accrued interest payments, and other forms of expenditures recorded above the line but not paid;

(iv) gross receipts from divestment;

(v) any exceptional financing.[3]

9. **Net external financing** of the central government is defined as the sum of:

(i) disbursements of project and nonproject loans, including securitization;

(ii) proceeds from bonds issued abroad;

(iii) exceptional financing (including rescheduled principal and interest), net changes in cash deposits held outside the domestic banking system,

(iv) net changes in short-term external debt;

(v) any change in arrears on external interest payments and other forms of external expenditures recorded above the line but not paid;

and less:

(vi) payments of principal on current maturities for bonds and loans on a due basis but excluding the use of IMF resources, and including any prepayment of external debt.

10. The floor on the primary balance of the central government before grants will be adjusted as follows:

(i) downward[4] to the extent that grants exceed programmed amounts as specified in Table 2.

(ii) upwards to the extent grants fall short of the programmed amounts as specified in Table 2 by more than EC$25 million through end-June or after.

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[3] Treasury bills will be recorded at face value, except for those held by the banking system which will be recorded on a purchase price basis.

[4] Downward adjustment means a higher deficit; upward implies a lower deficit.

(iii) downward to the extent that concessional financing from multilateral development banks exceeds programmed amounts (Table 2).

Table 2. Programmed Disbursements of Grants and Concessional Loans in 2006 (EC$ millions)

Quarter	I	II	II	IV
Grants	20	20	36.4	36.4
Concessional Loans	12.6	12.6	22.9	22.9

III. Indicative Target on the Net Credit of the Banking System to the Public Sector

11. **Net credit of the banking system** is measured as the change in credit of the domestic banking system to the public sector net of deposits, as reported by the consolidated balance sheet of the monetary authorities and commercial banks, including special tranches from the ECCB.

12. The ceiling on net credit of the banking system will be adjusted by the amount of required counterpart financing as follows:

(i) Upward[5] to the extent that grants fall short of programmed amounts up to a limit of EC$25 million through end-June or after;

(ii) Upward to the extent that concessional financing falls short of programmed amounts.

IV. Performance Criterion on the Central Government Arrears Accumulation to Domestic Private Parties and Public Enterprises

13. **Net changes in central government arrears to domestic private parties and public enterprises** is defined as the sum of all pending payments by the government for goods and services purchased from these parties, as well as pending interest and amortization payments on domestic debt, that have been outstanding for 60 days or longer. It also includes changes in arrears to the oil companies, which have resulted from the gas price subsidization arrangement, but have not been systematically recorded. The definition of domestic payment arrears excludes (i) debt claims that were irrevocably tendered in the debt exchange closed on November 15, 2005 ("the debt exchange"), and (ii) debt claims that were eligible to participate in the debt exchange but have not been tendered.

14. A ceiling is set on central government arrears to domestic private parties, equal to the stock of such arrears as per December 31, 2005 (Table 3). The ceiling will be monitored on a continuous basis.

[5] Upward adjustment means higher net domestic credit to the government.

Table 3. Stock of Domestic Arrears as per December 31, 2005
(in EC$ millions)

Unpaid checks issued	0
Unprocessed claims and Pending Invoices	2.99
Interest and amortization arrears on domestic debt	...
Arrears resulting from gas price arrangement 1/	18.15
Total stock of arrears	21.14

1/ Estimate

V. A. Performance Criterion on Nonconcessional Debt with an original maturity of At Least One Year contracted or Guaranteed by the Central Government

15. The ceiling on nonconcessional debt with an original maturity of at least one year will be applied to contracting or guaranteeing of debt by the central government .The contracting and guaranteeing of debt will be monitored and reported to the Fund staff by the Debt Unit (Economic Affairs) and the Accountant General's office on a monthly basis.

16. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received:

"(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lesser retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point [16(a)] above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

17. Excluded from the ceiling are credits extended by the IMF and credits on concessional terms provided by multilateral development banks.

18. Concessional terms are defined as terms implying a grant element (in net present value relative to face value) of more than 35 percent, based on the currency- and maturity-specific Commercial Interest Reference Rates (CIRR), published monthly by the OECD.[6] The limit excludes the disbursements of short-term import-related debts, the use of Fund resources, and refinancing operations.

V. B. Performance Criterion on the Net Changes in the Outstanding Stock of Short-Term External Debt with Original Maturity of Less than One Year Contracted or Guaranteed by the Central Government

19. The **stock of short-term external debt outstanding** is defined as debt with original maturity of less than one year contracted or guaranteed by the central government. The term debt is defined as set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85), August 24, 2000) (see paragraph [16] above), but excludes normal import-related credits.

20. The ceiling on short-term external debt will be applied on a continuous basis to the stock of short-term external debt owed or guaranteed by the central government.

[6] For loans with a maturity of at least 15 years, the 10-year average commercial interest reference rates and for loans with shorter maturities, the six-month average CIRRs, as of August 2006 published by the OECD will be used as the discount rates. To both the 10-year and 6-month averages, the following margins for differing repayment periods will be added: 0.75 percent for repayment periods of less than 15 years; 1 percent for 15–19 years; 1.15 percent for 20–29 years; and 1.25 percent for 30 years or more.

VI. PERFORMANCE CRITERION ON NONACCUMULATION OF CENTRAL GOVERNMENT AND CENTRAL GOVERNMENT GUARANTEED EXTERNAL PAYMENT ARREARS

21. **Central government and central government guaranteed external payment arrears** are defined as overdue payments (principal or interest) on debt contracted or guaranteed by the central government. The definition of external payment arrears under the program excludes: (i) debt claims that were eligible to participate in the debt exchange but have not been tendered, and (ii) debt claims of official bilateral creditors which are under rescheduling or refinancing negotiation.

22. No external payment arrears of the central government and central government guaranteed debt, will be allowed in the program. This ceiling will be monitored on a continuous basis.

VII. PERIODIC REPORTING

23. Regular reporting on a **monthly basis** will include the following:

24. Data for monitoring the program's performance criteria and monthly indicative targets, including

Fiscal sector

(i) Central government budgetary accounts.

(ii) Central government domestic debt data.

(iii) Current grant inflows.

(iv) Stock of domestic arrears, including unpaid checks issued, stock of unprocessed claims due and invoices pending; interest and amortization on domestic debt.

(v) Capital expenditure, including revised projections for the remainder of the fiscal year. Complementing to this monthly report, a detailed overview of expenditures on a project by project basis and the composition of financing will be provided on a quarterly basis.

Financial sector

(vi) Monetary survey for Grenada as prepared by the Eastern Caribbean Central Bank.

External and real sectors

(vii) Detailed (creditor by creditor) external debt report from the Debt Unit in the Ministry of Finance, showing fiscal year-to-date disbursements, amortization, interest payments, and outstanding stocks, for the central government and public enterprises.

(viii) Total disbursements/grant receipts, monthly, disaggregated into: (a) budgetary support (by type—either loans or external “bonds” and/or other securities); (b) project loans; (c) budgetary grants; and (d) project grants.

(ix) Copies of loan agreements for any new loans contracted, including financing involving the issue of government paper, and of any renegotiated agreements on existing loans.

(x) Stock of external arrears (creditor-by-creditor)

(xi) Consumer price index.

All such information will be provided to Fund staff, to the extent possible, within three weeks of the end of each month.

25. Reporting on an **annual basis** will include the following:

Fiscal sector

26. Financial statements of the public enterprises (as listed in paragraph 4)

External and real sectors

(xii) GDP and its components.
(xiii) Balance of payments accounts.

27. **Other reporting** will include:

(xiv) Reports of legislative changes pertaining to economic matters.
(xv) Notification of any establishment of new public enterprises.