

**FOR
INFORMATION**

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To: Members of the Executive Board
From: The Secretary
Subject: **Grenada—Assessment Letter for the World Bank**

Board Action: Executive Directors' **information**

Additional Information: The attached report on Grenada—Assessment Letter for the World Bank, is being reissued to replace FO/DIS/22/73 (4/27/2022), in which an incorrect version of the document was issued owing to an Administrative Error.

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Grenada—Assessment Letter for the World Bank

April 27, 2022

This letter updates IMF staff's assessment of Grenada's macroeconomic conditions and prospects, as well as macroeconomic and structural policies. The assessment has been requested in relation to the World Bank's proposed First Recovery and Resilience Programmatic Development Policy Credit (DPC) for Grenada.

1. Grenada is a small island state that is highly vulnerable to shocks. Strong implementation of economic reforms in 2014–19 addressed some of the key vulnerabilities in the fiscal, financial sector, business climate, and governance areas. However, the unfinished reform agenda and capacity challenges remain substantial and call for continued strong efforts. Grenada's membership in the ECCU's quasi-currency board arrangement has helped anchor inflation, but it limits the scope for domestic policy options should adverse events materialize. Reforms that bolster efficient public and private investment (including in resilience building and renewables), increase domestic value-added of the tourism sector, and enhance skills development and training are critical to improve competitiveness, promote growth and job creation, and strengthen resilience to natural disasters and other shocks.

Recent Developments, Outlook, and Risks

2. Grenada's economy was hit hard by the pandemic. Real output declined by 14 percent in 2020 from both a collapse of tourism-related activities and the suspension of in-person classes at Saint George's University (SGU). Growth in 2021 is estimated to have partly recovered to 5.6 percent, driven by construction and agriculture. The authorities' policy response—supported by the policy space that was created from the successful implementation of the Fiscal Responsibility Framework—has helped mitigate the pandemic's impact through containment measures and increased health, social and capital expenditure. Central government debt rose to 70 percent of GDP in 2021 (from 59 percent in 2019). The financial sector has so far weathered the crisis well.

3. The economy is projected to recover gradually from the pandemic. The war in Ukraine will affect Grenada primarily through commodity prices, representing an important headwind. Output is projected to expand by 3.6 percent in 2022, underpinned by construction activity, the gradual pickup in tourism arrivals, and the continued return of SGU students. Inflation is expected to further increase to 5.4 percent by end-2022, in line with rising global commodity prices, and to ease gradually. With a fiscal contraction envisaged for 2023, growth is expected to be driven by pent-up demand boosting consumption and the ongoing recovery of tourism-related activities (with tourism export receipts projected to return to the 2019 level by 2025). Output is expected to return to its pre-pandemic level by 2024 and then gradually converge back to potential by 2027.

4. External financing needs are projected to remain large in 2022. The current account deficit widened significantly in 2020–21, and staff assesses Grenada's external position in 2021 as weaker than implied by fundamentals and desirable policies, once adjusted for the expected

transitory nature of the tourism shock. Despite stronger-than-expected inflows via the Citizenship-by-Investment (CBI) program, weaker FDI led to a deterioration in the financial account. The current account deficit is projected to worsen further in 2022 given the sharp increases in import prices, before improving in 2023 supported by increases in tourism export receipts and moderation in fuel imports. In this context, staff estimates that meeting the financing needs will require significant financing from the IFIs and other donors.

5. Risks around the outlook are high. The main risks to the outlook are a further increase in food and oil prices and prolonged supply chain disruption given the war in Ukraine (which could lead to further increases in inflation including through second-round effects) and/or a more prolonged pandemic (with implications for tourism recovery and return of SGU students). Either of these forces could weigh on the recovery, require additional government spending, and exacerbate fiscal and external imbalances. Other external risks include a sharp rise in global risk premia (which could reduce liquidity and credit provision domestically) and natural disasters—with the potential for increased severity due to climate change. Domestically, a sharp rise in pension liabilities to realize the contested legacy debt poses an important downside risk. On the upside, reduced hesitancy and accelerated vaccinations, breakthroughs in COVID treatment, higher deployment of public investment, and faster implementation of reforms to improve competitiveness could support a stronger recovery.

Fiscal Policies

6. The authorities' counter-cyclical fiscal efforts, facilitated by the triggering of the escape clause under the fiscal rules in 2020–22, have been essential to help return the economy as quickly as possible to the pre-pandemic levels of activity. Through 2019, the government was consistently overperforming with regards to the key targets under the fiscal responsibility framework. In 2019, the primary surplus had reached 6.8 percent of GDP, and central government debt had declined to 59 percent of GDP, from 105 percent in 2013. However, public debt rose to 71 percent of GDP in 2020, due chiefly to the pandemic-induced collapse in GDP, and the primary surplus declined sharply to 2.1 percent of GDP in 2021 and is expected to swing into a deficit of 1.5 percent of GDP in 2022. The immediate policy priorities are to accelerate vaccination and provide time-bound fiscal support. It will be important to allow higher international food and energy costs to pass through to domestic prices alongside targeted support to protect the vulnerable.

7. Barring unforeseen events, the fiscal rules should come back into force in 2023. The rules have provided fiscal credibility and gave the government room to maneuver when the pandemic hit. To sustain the recent increase in public investment in resilient infrastructure, it will be important to secure concessional financing and mobilize domestic resources. The government should design and implement a comprehensive pension reform to improve the financial position of the pension system. The recent court ruling in favor of public servants' claims can potentially give rise to additional liabilities for the government. A contingency plan should be developed to handle various possible outcomes that would allow Grenada to maintain its prudent path of debt reduction. The efficiency of public spending can be strengthened, through better public investment

management, an accelerated implementation of the 2017 Public Service Management Reform Strategy, and better targeting of social assistance programs.

8. The current conjuncture provides an opportunity to carefully reconsider the design of the fiscal framework. The framework should be centered on the medium-term debt ceiling, reduce overlaps in the numerical rules, and provide clear procedures to return to the targeted debt path following shocks. Fiscal transparency would be enhanced by timely publishing audited financial statements of the public sector and of state-owned enterprises.

9. The draft DSA, which is being carried out with the World Bank for the 2022 Article IV consultation, reaffirmed the joint DSA assessment of the request for access under the Rapid Credit Facility (RCF) in April 2020. The draft DSA concludes that Grenada’s external risk rating remains high and public debt is sustainable, despite a moderate deterioration in debt indicators and the “in distress” rating due to arrears to three official bilateral creditors, which are not new relative to what was reported under the RCF. The authorities are making good faith efforts to reach an agreement on outstanding arrears (totaling about US\$25 million). Going forward, regularization of arrears will be needed to support an upgrade of the risk rating. The assessment that debt is sustainable is predicated on the authorities’ strong commitment to the fiscal responsibility framework, fiscal structural reforms, and further improvement in debt management. Grenada’s debt vulnerabilities would be mitigated by proposed reforms to strengthen debt transparency, a more proactive and layered financial buffers to cope with disaster risks, and ongoing efforts to advance climate resilience building.

Structural Policies

10. The government should aim to facilitate a shift in the tourism model toward higher value-added. This can be achieved by working with local producers to align output with the demands of hotels and restaurants. A diversification of the sources of tourism can be achieved by increasing the number of flights, leveraging the presence of Saint George’s University to offer health services to visitors, and advancing investments in fishing and eco-tourism ventures.

11. Implementing Grenada’s Disaster Resilience Strategy should continue to receive a high priority. The establishment of a public asset registry will help prioritize maintenance spending on critical resilient infrastructure. Working with the private sector to enforce building codes and broaden insurance coverage—particularly catastrophic risk insurance—will help in responding to natural disasters. The legislative framework for the Disaster Risk Management Act should be finalized and a “risk map” for hydro-meteorological and geological hazards should be developed to help guide scenario planning and disaster response.

12. To increase its competitiveness, Grenada should accelerate the shift to renewable energy. This can be supported by regulatory adjustments, changes to construction standards, and incentives to invest in renewables. It will also be important to allow fossil fuel prices to adjust to changes in international markets. To address the long-standing skill mismatch, the authorities should continue to provide training programs and improve their effectiveness.

Financial Sector Policies

13. The financial sector policies are largely in the purview of the ECCB and subject to the constraints of the quasi-currency board arrangement. Grenada's financial sector entered the COVID-19 outbreak with sizable buffers. The financial sector has weathered the pandemic well. Nonperforming loans (NPLs) in credit unions rose to 7.2 percent of total loans in end-2021 (from 5.2 percent in end-2019) but those among banks remain low. With the prolonged strains in the broader economy, NPLs look set to rise (especially as moratoria and regulatory forbearance are removed). Bank loan loss provisioning meets the ECCB's recently-revised guidance (of 60 percent of NPLs) but credit union provisioning should be bolstered. Banking system profitability (return on assets) has declined from 1.4 percent in 2019 to 0.3 percent in 2021 reflecting the challenging economic situation. Given the country's vulnerability to natural disasters and climate change, there is a need to strengthen the monitoring of climate-related financial stability risks, particularly for the insurance sector.

14. The oversight of credit unions needs to be strengthened. Although much smaller than the banking sector, credit unions have grown rapidly in the last decade, are highly concentrated (the top three account for 89 percent of sector assets), and make up a substantial fraction of domestic credit. The Grenada Authority for the Regulation of Financial Institutions (GARFIN) appropriately enhanced the frequency and intensity of oversight of credit unions during the pandemic. Efforts should continue to ensure there are routine stress tests, governance is strengthened, capital requirements are increased, and more granular data is collected and published.

15. Continued efforts to strengthen the anti-monetary laundering and combating financing of terrorism (AML/CFT) framework will be critical to lessen risks to correspondent banking relationships. To strengthen financial integrity, Grenada has designated the ECCB as the competent AML/CFT authority for banks. Cooperation between Grenada Authority for the Regulation of Financial Institutions, Grenada's Financial Intelligence Unit, and the ECCB can be increased. Due diligence of the CBI program should remain attentive to risks to the integrity of the program, including through continued strengthening of its oversight and transparency.

Fund Relations

16. Grenada is on a standard 12-month Article IV consultation cycle. The 2019 Article IV consultation was concluded on June 12, 2019. On April 28, 2020, the IMF Executive Board approved SDR 16.4 million (equivalent to 100 percent of quota or 2.1 percent of GDP, about US\$22.4 million) in emergency financing under the IMF's RCF to Grenada to provide budget support in their effort to contain the pandemic and address the socio-economic fallout from the COVID-19 shock. Grenada also took advantage of the G-20 Debt Service Suspension Initiative (DSSI) to help fill its large external financing needs. The 2022 Article IV consultation mission was conducted during February 15–25 in Saint George's and the Board meeting is scheduled for May 4, 2022. Grenada is a major recipient of IMF technical assistance, including from the Caribbean Regional Technical Assistance Centre (CARTAC).

