***SOVEREIGN*: GRENADA** **March-9-2018**

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPEDIX

Summary

Erratic real economic growth rates leading up to 2014 caused the government to pursue expansionary fiscal policy, which was largely unsuccessful because of the low impact of government spending on growth. To help clear arrears and pay down the high cost debt the government issued a global bond in 2012 amounting to 25% of GDP. Two back-to-back hurricanes in 2004 and 2005 severely affected the country causing millions of dollars in damages to infrastructure and the public housing stock and destroyed the entire nutmeg crop. Saddled with a high debt burden and limited fiscal space, the sovereign experienced serious challenges servicing the debt and solvency consequently became an issue. The government engaged creditors in 2004-2006 to restructure the debt. In the agreement reached between the parties there was no nominal haircut and maturity was extended, which provided temporary liquidity relief.

High fiscal outlay on post-hurricane reconstruction coupled with low economic growth and an increasing fiscal deficit caused debt levels to increase and exacerbated concerns about debt sustainability. Credit also dried up because of the perceived sovereign risk. The growing external vulnerability and deteriorating fiscal conditions caused the government to engage the International Monetary Fund (IMF) to help fund and design a programme to improve the macro-fiscal trajectory. As a condition precedent to an agreement, debt restructuring was placed on the agenda. The Government again engaged creditors in 2013-2015 to restructure the debt. The terms of the agreement reached between the parties included a nominal haircut and extension of maturities.

Macro-fiscal conditions have vastly improved since the second debt restructuring, but low fiscal and external buffers leave the sovereign highly susceptible to shocks. The debt is on a downward trajectory and debt servicing is more manageable. However, there are lingering concerns regarding the past actions of the sovereign and the ability to withstand shocks.

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Snippet of the Sovereign

Credit Strength

- Stable parliamentary democracy and legal system strongly rooted in English common law
- Fixed exchange rate reduces domestic inflation impulse arising from increase external prices
- Relatively stable economy with low inflation and moderately high per capita GDP

Credit Weakness

- Small island economy with narrow economic render the sovereign highly susceptible to shocks
- Elevated debt levels limit public spending and there is no room for monetary policy flexibility
- Low external and fiscal buffers to cushion the effect of shocks

Ratings: S&P

Overview

Located in the South-eastern section of the Caribbean Sea, Grenada measures 384 square kilometres and is located northwest of Trinidad and Tobago and south east of Venezuela. The island was primarily settled by Carib Indians before the French began the process of colonisation in 1650. Grenada was thereafter ceded to the British under the Treaty of Paris in 1763 who ruled until 1974, except for a brief period of French occupation from 1779 to 1783. Eric Gairy became the first prime minister following independence in 1974. In March 1979 he was overthrown in a coup d'état by the Marxist New Jewel Movement under the leadership of Maurice Bishop. Bishop, a moderate Marxist, was deposed and killed by hard line party members in October 1983. The USA led a joint Caribbean force to invade the island and restore democratic rule. Elections were held in 1984 and Bernard Blaze was elected prime minister and served until his death 1989.

The Queen of England is the head of state in Grenada. She is represented by a governor general who is appointed on the advice of the prime minister. Grenada is a parliamentary democracy with two houses of Parliament, the lower house and the upper-House. Fifteen members of the lower house are elected via the first-past-the-post election system and the party with the larger majority is invited by the governor general to form the government. Two political parties, the New Democratic Congress (NDC) and the New National Party (NNP), dominate the political landscape. The NDC forms the government having won all 15 seats in general elections in 2013 and Dr. Keith Mitchell is the current prime minister.

In September 2004 Grenada was ravaged by a category 3 hurricane, Ivan, which took a direct path over the island and damaged or destroyed nearly 90% of homes. In July the following year the island was struck by Hurricane Emily, a category 1 hurricane, which caused damage estimated at US$ 900 million. It is estimated in 2017 that the population of Grenada was around 108,000 and per capita GDP was US$10,100.

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GDP Growth and Debt Sustainability

In the two decades after independence leading up to early 2000, real GDP accelerated in Grenada and grew at an annualized rate of 4.5% due to preferential access for agriculture products in the European Union (EU) and tourism. The growth rate however became more volatile in years leading up to 2004 due to the ending of preferential access to the EU. This caused the government to accelerate spending, particularly on capital projects, which however did not have the desired growth outcomes due to a low fiscal multiplier. Consequent on higher fiscal outlay and low growth, the fiscal deficit and debt level increased. In 2002 the government issued a 10 year US100 million global bond with a coupon of 9% to help clear arrears and pay down high cost debt. The issuance deviated from the government debt strategy, which among other things, prioritises concessional financing from multilateral and bilateral sources. ***The global bond issuance amounted to 25% of GDP and debt levels rose from 35% in 1999 to 80% in 2002.***

Hurricane Ivan (2004) and Hurricane Emily (2005) caused major damage to public infrastructure and wiped out the entire nutmeg crop. Tourism and agriculture which when combined accounts for over 25% of GDP were severely affected by the storms. Ivan in particular is estimated to have cause US$900 million (200% of GDP) in damage of which around US$600 million was attributed to damage to the housing stock. A combination of slow real GDP growth and increased spending caused the debt level to spike to 130% at end-2004 and the IMF projected that it would increase to 150% by 2010. In the main Grenada's debt dynamics were unsustainable as the sovereign was facing solvency issues and direct intervention was needed to bring the debt under control.

First Debt Restructuring: 2004-2006

In October 2004 the Government announced its intention to negotiate terms with the investment public to restructure the debt to address the solvency issue in a bid to create needed fiscal space to pursue the reconstruction and rehabilitation of the country's infrastructure and stabilize the economy. Assistance was also sought from the multilaterals including the Caribbean Development Bank, World Bank and the IMF. At the commencement of the negotiations the Government missed payment on the international bond in December, resulting in Standard and Poor's (S&P) downgrading the sovereign credit to "Selective default" (SD).

The Government targeted all debt for restructuring with the exception of external official creditors and T-bills. Bilateral creditors were targeted for debt forgiveness or concessional terms on par with commercial credit. A broad based investor committee was formed representing 70% of investors or just around US$171 million of the total external credit. Dialogue commenced in earnest between the government and creditors with the government maintaining transparency by disseminating germane macroeconomic data on a timely basis. The focus of the negotiations was to secure near-term cash relief to help with the sovereign's reconstruction needs.

After a lengthy dialogue with creditors, a debt restructuring proposal was issued by the government. The proposal sought to consolidate all domestic and external holdings, including arrears, into two separate bonds denominated in EC- and US-dollars amounting to US$248 million combined. The bonds were issued at par and were scheduled to mature in 2025, with amortisation starting in 2020 and with a step-up coupon feature to further ease the cash burden. On November 15, 2005, the commercial debt restructuring was concluded, covering the equivalent of approximately 47% of the total public debt.

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The EC-dollar bond was issued under local law while the US-dollar bond was issued under New York law.

Second Debt Restructuring: 2013-2015

Having embarked on a fiscal programme to cauterize the deficit and place the debt on a sustainable path, the world financial crises in 2008-2009 caused fallout in tourism and slowdown in post-hurricane construction activities which adversely impacted real economic growth. The government, against the dictates of international financial partners, embarked on counter-cyclical spending to help accelerate economic growth. Again this did not have the desired outcome, as the fiscal multiplier was weak. During the period 2007-2011 the cumulative growth rate was flat while the cumulative fiscal deficit mounted to 20.8% (4.2% per year on average). Consequently, the debt level increased 18 percentage points over the period to 107% at the end of 2011.

Following the first debt exchange Grenada was cut off from the external financial markets and relied on multilateral and domestic bank credit. However mounting debt made securing funding for the budget challenging, as cash from multilaterals dried up and domestic banks limited their exposure.

A new government with a clear mandate came into office following general elections in 2013. The administration commenced discussions with the IMF and after lengthy negotiations a Staff-level agreement was reached following the Board approval of a three-year Extended Credit facility (ECF)-supported programme in June 2014. The programme, among other things, sought to secure fiscal and debt sustainability through fiscal adjustments; fiscal legislative reforms; and debt restructuring, as despite the revenue and expenditure measures envisaged, the debt dynamics under the current debt structure was unsustainable.

In March 2013 the government announced its intention to pursue a comprehensive debt exchange programme. Following the announcement, debt payments fell into arrears, which helped to alleviate liquidity pressures. The government again engaged creditors to pursue its debt agenda and in March 2015 terms were reached between the Government and private creditors on the US- and EC-dollar bonds.

Table 1: Summary of External bond restructuring

	First Restructuring	Second Restructuring
Face value reduction	None	50%
Capitalization of past-due interest	yes	yes
Change on coupon structure	yes, step-up and lower	yes, fixed
Maturity expansion	11.7 years on average	5 years
NPV haircut	38.40%	49%
Use of Collective Action Clause (CAC) and no exit consent	No	CAC on US$-denominated bonds
New clause: Hurricane and Revenue sharing of Citizenship by Investment Programme	No	yes

Source: IMF and JMMBIR

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Monetary Policy and Inflation

Grenada is part of Organisation of Eastern Caribbean State (OECS) which is an inter-governmental organisation with a mandate to foster economic harmonisation and integration among ten Caribbean countries, including Anguilla, Antigua and Barbuda, The British Virgin Islands (BVII), Dominica, Martinique, Monserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

With the exception of Martinique and The BVI, all the other islands operate under the umbrella of the Eastern Caribbean Central Bank (ECCB), which was established in 1983 and is the monetary authority for the group. The group uses a common currency, the Eastern Caribbean (EC) currency, which is pegged to the US dollar at an exchange rate of EC$2.7 to US$1. The reserves for the territories are pooled and, among other things, the ECCB regulates and controls credit across the region. Owing to the fixed-exchange rate regime, monetary policy is rigid and as such economic conditions in Grenada are mainly influenced by fiscal policy.

Grenada is heavily dependent on imports and as a result of this domestic prices tend to reflect movements in international prices, in particular fuel and other commodities. As opposed to other small island states with variable exchange rates, the currency peg limits the pass-through effect of international price volatility on the wider economy. Inflation is relatively subdued and is expected to remain stable over the medium-term, in line somewhat with expected changes in international prices.

Macro-Fiscal Outlook

Since 2014 Grenada has implemented structural reforms to address debt sustainability and fiscal imbalances. The IMF in its Review on the economy in March 2017 noted that Grenada has implemented "reforms and made progress toward achieving the key program goals of restoring fiscal sustainability, strengthening the financial sector, and setting the stage for durable growth." Debt-to-GDP is expected to fall to 72% in 2017 compare to 103% before the start of the Fund-aided programme in 2013. The fiscal deficit has trended to a surplus of 2.4% in 2016 and is broadly expected to remain that way through to the medium term. As a result of improvements in the fiscal accounts and real GDP growth and the debt restructuring, the debt is expected to remain on a downward path through to the medium term.

The external accounts have shown some improvements but remain vulnerable to external shocks. The current account (CAD) deficit moved from 26% of GDP in 2010 to an estimated 3% in 2017 and is likely to remain low over the medium term. Imports however remain high and improvements in the CA are being driven by higher tourism receipts. No mark shift is expected in reserves and import cover over the medium term.

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Table 2: Selected Macroeconomic Data for Grenada

Indicator Name	2010	2011	2012	2013	2014	2015	2016	2017(e)	2018 (f)	2019 (f)	2020 (f)
Population	104,677	105,075	105,481	105,909	106,360	106,823	107,317	107,825	108,339	108,825	109,308
GDP per capita, USD	7,365	7,410	7,583	7,954	8,572	9,154	9,656	10,133	10,608	11,114	11,656
Real GDP, % y-o-y	-1	1	-1	2	6	5	4	3	3	3	3
Inflation, % y-o-y, eop	4.2	3.5	1.8	-1.2	-0.6	1.1	0.9	1.8	2.0	2.0	2.4
Central bank policy rate, % eop	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50	7.00	7.50	8.00
Goods imports, % of GDP	37.0	37.9	37.5	38.5	33.5	33.5	30.4	30.3	29.6	29.4	29.1
Current account balance, % of GDP	-26.4	-26.6	-24.2	-26.3	-4.4	-3.9	-3.3	-3.0	-2.2	-2.0	-1.9
Foreign reserves ex gold, USDbn	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.2	0.1	0.2	0.2
Import cover, months	3.8	3.7	3.6	4.3	3.6	3.3	3.2	3.1	3.0	2.9	2.8
Public external debt stock, % of GDP	67.7	66.3	64.9	61.6	59.1	58.4	55.0	81.6	78.6	79.9	77.8
Total government debt, % of GDP	96.9	100.7	103.3	106.8	101.8	91.7	83.4	71.8	66.0	62.0	58.7
Total debt service, % of GDP	3.6	3.4	2.0	4.3	2.8	2.8	3.4	-	-	-	-
Interest payments, % of GDP	1.6	1.6	1.2	0.8	1.3	0.9	1.0	-	-	-	-
Interest payments, % of XGS	6.6	6.4	4.5	3.2	4.9	3.6	3.7	-	-	-	-
Exchange rate: XCD/USD, eop % y-o-y	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70
Total revenue, % of GDP	22.4	23.1	20.7	20.6	24.5	24.9	26.9	26.7	26.2	25.6	25.1
Fiscal balance, % of GDP	-2.4	-3.2	-5.5	-6.5	-4.7	-1.2	2.4	2.8	2.5	2.2	2.0
Capital expenditure, % of GDP	5.2	6.3	5.0	6.8	9.2	8.5	4.3	4.2	4.1	4.1	4.0

Source: Business Monitor International/JMMBIR

Relative Value Analysis

Figure 1: Relative value of Grenada 2030 to other LATAM Sovereign Bonds

Source: Jeffries and JMMIR
JMMB assigns a value of B- to Grenada 2030 based on the sovereign's macro-fiscal profile.

The outstanding amount on the Grenada 2030 global bond is US $112.3 million and the coupon is 7%. From a relative value perspective, the bond is undervalued as its yield is 200 basis points higher than where a bond of similar maturity, tenor and ratings are expected to trade. This may be indicative of the markets perception regarding the sovereign's risk as well as the built-in risk premium required to compensate for past debt actions.

Although the bond can be purchased in increments of US$100 it is not easy to source as it is not widely traded.

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Recommendation

Grenada has experienced significant improvements in the fiscal accounts subsequent to the debt restructuring in 2014. The fiscal accounts have moved into surplus and the debt, though still high, is on a downward path. The CA has swung into surplus, but the external accounts overall remain weak. Notwithstanding the improvements, Grenada remains vulnerable to external shocks, as there are little fiscal and external buffers. Tailwinds from real GDP growth in the US is expected to drive growth in tourism and related-construction activities. Hence growth in real output is envisaged at 3% per annum over the medium term.

Grenada is committed to paying the debt however we cannot ignore past credit actions and the sovereign's vulnerabilities, as shocks could easily cause a reversal of the progress made in fiscal and debt sustainability. The Grenada 2030 is undervalued compared to bonds of similar tenor on the Latin America and the Caribbean curve. However, we are of the opinion that only persons with a high risk appetite and large enough portfolio to cushion the effect of price volatility should hold this asset. The bond is not widely traded, which raises concern about offloading it quickly if required. **Given the sum total of the sovereign's credit history, risk profile and macro-fiscal path we are recommending Grenada as underweight**.

Source:

Bloomberg
Business Monitor International
https://www.cia.gov/library/publications/the-world-factbook/geos/gj.html
IMF Working Paper "Sovereign Debt Restructurings in Grenada: Causes, Processes, Outcomes, and Lessons learned" by Tamon Asonum et al.

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

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