



SEYCHELLES

How Classic Policies Restored Sustainability

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Seychelles: How Classic Policies Restored Sustainability

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Preface



James A. Michel
*President of the Republic
of Seychelles*

Much has been written about the history of Seychelles, but no one has in any significant way addressed the economic history of our nation. This book deliberately does not cover all of Seychelles' history. It concentrates on the three decades since independence in 1976, with particular attention to the period leading up to the 2008 debt crisis and the four years that followed. It gives a good account of the policies that prevailed during that time and the decision by the Government to enter into a historic first IMF-supported adjustment program to overcome the crisis.

Above all, this book is a riveting account of how Seychelles came together as a nation to transform its economy remarkably in a very short time. It is a story about the vision of its leaders and the hard work of its civil servants who helped steer the program through. More tellingly, it is the story of a people acutely aware of the personal hardships they would have to face and the sacrifice they would have to make in the short to medium term to secure their survival, and their future. It is about a small nation's resilience in the face of overwhelming odds, of turning challenges into opportunities by accepting and claiming full ownership of the IMF-supported program of macroeconomic reform. The people took ownership of the program because they were consulted and they understood fully what it entailed, both at a personal and national level. Once the people of Seychelles took ownership of the program, its success was assured even though hard times were to be expected.

Readers will no doubt find the build-up to the program interesting. To me however, the most revealing is the lesson and message that the book conveys. Too often economies are allowed to slump deeper and deeper into crisis simply because leaders are reluctant to make tough decisions because they are concerned about possible social unrest. In 2008 I realized that the time had come for a fundamental

change in the way our economy was managed. I knew I had to put political considerations aside and place the future of my country above everything else. I was aware that I was taking a massive political gamble, but I was prepared to do it because I was convinced that it was not only the right thing to do but also the only option to extract Seychelles from the crisis. I knew that the people of Seychelles needed a major change in mindset, to move away from a cycle of economic dependency and reliance on government social services to a new attitude of “get up and do something for yourself”—“*leve debrouye*,” as we say in Creole. Events and developments were to prove me right.

We stayed the course and did not waver, not even when confronted by the exigencies of politics. In 2011, before the presidential election, given what was at stake I was strongly advised to defer further movement on the program. I refused, stating that I would stand firm and that the reforms would continue in spite of everything. In fact, I insisted that I would use the reform program as my re-election platform! My re-election, with close to 56 percent of the vote, demonstrated clearly the trust of the people in my political and economic direction and their support for the program. I must pay tribute to them for their trust, their resilience, and their endurance.

Today, less than five years after adoption of the program, we have an economy built on solid fundamentals and investor confidence. We have faced many challenges and, with intelligence and fortitude, we have overcome them.

Seychelles: How Classic Policies Restored Sustainability is a true story but it is also a parable about the success that comes from accepting one’s mistakes, abandoning what is not working, having the will to transform, having the courage to embrace reform and implement tough policies, putting the interests of the country first above any political considerations, and bringing hope to the people so that they can enjoy a more prosperous future. I hope that through this book others will find the inspiration and courage to bring hope and economic prosperity to their people.

Foreword



Makhtar Diop
*Vice-President, Africa
Region World Bank Group*

This book documents a story that has never been told. For a decade before 2008, the Seychelles economy had been drifting away from basic economic principles (despite apparent prosperity) until it hit a wall. The government turned the ensuing balance of payments crisis into an opportunity. With commitment and leadership from the highest level, they implemented a complete and coherent set of reforms: they liberalized the exchange rate, tightened fiscal policy (including layoffs where needed), reduced the role of the state in commercial activities, and introduced a sound monetary policy framework that targeted reserves. Thanks to widespread consultations beforehand, the reforms enjoyed popular support. More to the point, they worked. In a record three years, Seychelles fixed its economic fundamentals, secured generous debt relief from the Paris Club and other private creditors, and today enjoys rapid—and likely sustained—growth.

But the Seychelles story is about more than how established economic doctrine can work today, although that in itself is worth telling. It also offers useful lessons for other countries facing similar difficulties: First, an economy in crisis can be directed onto a sustainable growth path. Second, timid economic reforms in response to warning signs—the reaction up to 2008—are not likely to prevent a decline. Third, in a crisis, reforms cannot be piecemeal—it is better to overshoot rather than undershoot. Fourth, the “home-grown” nature of a program can be preserved while putting international technical assistance to good use. Finally, reforms can be painful and touch the lives of many people, reinforcing the importance of a good safety net.

The Seychelles economy is on track, but the authorities recognize that sustaining the gains will require second-generation reforms to deal with such structural issues as education quality, reform of state-owned enterprises and public utilities, and the need to build competitiveness. These may prove difficult precisely because

the country has already achieved so much—such as universal, free health and education—with first-generation reforms. There is a danger that it could become a prisoner of success. But the way the government and people of Seychelles managed the balance of payments crisis of 2008 makes me confident that they will once again rise to the challenge.

Acknowledgements

Seychelles: *How Classic Policies Restored Sustainability* was prepared by a team led by World Bank economist Sawkut Rojid and consisting of Emilio Sacerdoti, Senior Advisor to the Government of Seychelles, and Ahmed Afif, former Principal Secretary of the Seychelles Ministry of Finance, Trade, and Investment.

The work benefitted from the much-appreciated guidance of His Excellency Danny Faure, Vice President of the Republic of Seychelles; the Honorable Pierre Laporte, Minister of Finance, Trade, and Investment of the Republic of Seychelles; Shanta Devarajan, World Bank Chief Economist for Africa; Haleh Bridi, World Bank Country Director for Seychelles; and John Panzer, World Bank Sector Manager for Poverty Reduction and Economic Management .

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Ahmed Afif holds a bachelor's degree in mathematics and economics from Warwick University. Now working in the private sector, he previously worked for the Central Bank of Seychelles, was chief executive of the Seychelles International Business Authority, and served in the Seychelles President's Office in various capacities related to formulation of economic policy. In 2008, he was appointed principal secretary of the Ministry of Finance, where he had a central role in designing and executing major macroeconomic reforms.



Emilio Sacerdoti holds an MPhil and a PhD in economics from Yale University. He worked in the Research Department of Banca d'Italia in 1973–75 and as assistant to the IMF executive director for Italy in 1976–78. From 1978 through 2009 he held positions in a number of IMF departments as economist, senior economist, division chief, and advisor. Since 2009 he has been a senior advisor to the Ministry of Finance of Seychelles and

consultant to the World Bank, the African Development Bank, and the European Development Fund.

Abbreviations and Acronyms

| | |
|----------|---|
| BADEA | <i>Banque Arabe de Développement Economique en Afrique</i> (Arab Bank for Economic Development in Africa) |
| COI | Conserverie de l’Océan Indien |
| COSPROH | <i>Compagnie Seychelloise de Promotion Hôtelière, Ltd.</i> |
| DBS | Development Bank of Seychelles |
| ECCU | Eastern Caribbean Currency Union |
| ECP | East Coast Land Reclamation Project |
| FDI | Foreign direct investment |
| GDP | Gross domestic product |
| GNI | Gross national income |
| GST | Goods and services tax |
| HDI | Human Development Index |
| HFC | Housing Finance Corporation (HFC) |
| HIV-AIDS | Human Immunodeficiency Virus – Acquired Immune Deficiency Syndrome |
| IMF | International Monetary Fund |
| LAR | Loan asset ratio |
| MICs | Middle-income countries |
| MLUH | Ministry of Land Use and Habitat |
| MW | Megawatt |
| PIT | Personal income tax |
| PMC | Property Management Corporation |
| PSIP | Public Sector Investment Program |
| PUC | Public Utility Company |
| SDP | Seychelles Democratic Party |
| SHDC | Seychelles Housing Development Corporation |
| SMB | Seychelles Marketing Board |
| SPUP | Seychelles People’s United Party |
| SR | Seychelles rupee |
| SWA | Social Welfare Agency |

| | |
|------|--------------------------------------|
| UNDP | United Nations Development Programme |
| US\$ | United States dollar |
| VAT | Value added tax |

Introduction

In its three decades of independence, Seychelles has forged a world-class private tourism industry that has consistently fortified its economic growth. Yet with an underlying economic model characterized by extensive state intervention in the economy and an extensive welfare system, Seychelles accumulated debt that was unsustainable. Eventually, with its foreign exchange reserves all but depleted, the country could not honor its obligations to foreign creditors. The global economic crisis of 2008 exacerbated those conditions, impelling Seychelles to put in place substantive and fundamental economic reforms. Beyond expectations, those reforms turned the crisis around in a record three years—a much-acclaimed success.

Since independence Seychelles' economic development has been remarkable. It is a story of steady income growth, significant investment in infrastructure and tourism, and a steady increase in the welfare of its citizens, who have the highest per capita income in all of Africa. Owing to the rapid growth of tourism and the high tax revenues it has produced, the government has been able to firm up infrastructure and create comprehensive social services and welfare systems.

This remarkable growth, however, depended on steady borrowing, especially in the 1990s and early 2000s, and was accompanied by severe trade and exchange restrictions. Borrowing ultimately proved unsustainable as debt reached almost 200 percent of gross domestic product (GDP). Starting in 2008 external debt required massive restructuring. With vigor, Seychelles undertook comprehensive, deeply owned macroeconomic reform, supported by the International Monetary Fund (IMF), the World Bank, the European Union (EU), and other partners.

The economic restructuring gave priority to liberalizing foreign exchange, significant and sustained tightening of fiscal policy (backed by a reduction in public employment), reform of monetary policy to emphasize liquidity management, and a reduction in the state's role in the economy to help build the private sector. With generous debt relief from the Paris Club and other private creditors and with fiscal consolidation Seychelles managed to achieve a sounder fiscal and debt status than had prevailed only a few years before. By addressing macroeconomic imbalances,

Seychelles improved its prospects. In 2010 and 2011 real GDP growth averaged 5 percent, public debt had fallen by more than half compared to 2003, and healthy primary fiscal surpluses peaked in 2009 at 14.8 percent of GDP.

Although Seychelles may be only a very small country in the context of the world community, the political economy of reform is as complex there as in any other country of any size. For that reason, Seychelles' success in executing challenging reforms despite economic uncertainty offers useful lessons to all. These lessons may encourage other countries to embark on ambitious reforms to set, or reset, a similar course toward stability, growth, and long-term sustainability.

This book describes four decades of macroeconomic policies that eventually made Seychelles' debt unsustainable. It highlights the discussions that culminated in a decision to make drastic changes, and it presents details of the reform program. The book concludes with a summary of useful lessons that can be drawn from the Seychelles experience.

Debt-Promoting Economic and Sectoral Policies

The bold, ambitious reform program that Seychelles started in 2008 was rooted in economic policies enacted in the early decades after independence in 1976. Important features of the Seychelles economy evolved toward crisis over several distinct periods.

The 1970s to the 1990s: From Independence to the End of the Cold War

Seychelles has a comparatively short history of development as an independent nation. France laid claim to the islands in 1756, and the first French settlers arrived in 1770 (preceded by occasional temporary influxes of pirates). In the ensuing decades, more settlers arrived, as did an increasing number of freed slaves from mainland Africa, the islands' nearest neighbor. A master-slave mentality arose during this first known continuous period of habitation.

Since then, much has transpired in Seychelles: Great Britain eventually won control from France in 1811. This period of colonization saw substantial construction of churches, schools, roads, bridges, and transport and communication systems. The country was by then markedly divided by economic class: Descendants of the original settlers owned much of the land and assets, and the slaves and other laborers who came after them were relegated to a low-income working class. But then successive world and economic crises and the evolution of a credible voting and political system gave birth to a new political orientation.

In 1962 the populist Seychelles People's United Party (SPUP), formed initially to advocate more equitable distribution of wealth, demanded independence from British colonial rule. In response the Seychelles Democratic Party (SDP), backed by the elite—largely landowners and the business community—took a right-wing stance.

The country became independent on June 29, 1976, and the head of the SDP, James Mancham, was declared president. Barely a year later, on June 5, 1977, a coup ousted President Mancham while he was in London attending Queen Elizabeth II's silver jubilee celebration. The SPUP rose to power, and France Albert Rene was eventually declared president of a one-party state.

The new regime had one immediate reform in mind: to redistribute wealth, including land and capital. Thus began a process in which the government acquired large tracts of land from the traditional owners, who over the course of two and a half centuries had amassed extensive holdings. The process was not easy; often arbitration was necessary. Even today some cases are still pending, in court or in negotiations for a final settlement.

The administration viewed the land acquisition policy as meeting an economic need. Land as a resource needed to be fully utilized to support economic activity and meet growing housing and other development needs. Mahé, the main island, has very little flat land to support many competing uses: housing, agriculture, and economic activities such as tourism, services, and manufacturing.

An equally important priority for the new government was job creation. The government therefore set up new public enterprises that covered a very wide economic spectrum: public transport (including air), the hotel and hospitality industry, retail and manufacturing, import services, agriculture, port and marine services, energy services, banking services, medical services, schools and education, public works and utilities, and island development.

The government thus soon became the principal economic actor in Seychelles; it was not only chief regulator but also a very large employer. It considered its role to be investing in new businesses, particularly in manufacturing, to create jobs. Government policy was oriented to tight state control of all parts of the economy, including importing and marketing consumer products through the Seychelles Marketing Board (SMB). Eventually state-led monopolies produced canned tuna, juice, milk, bottled water, yogurt, coconut cream, snacks, animal feed, prawns, fresh and frozen fish, and blocks, aggregate, and other construction materials (although this last industry always had private competition).

Tourism had started to grow even before independence, when the Seychelles International Airport became operational in 1971. The airport allowed jets to land on Mahé and gave (primarily European) visitors convenient access to the islands. The state nationalized some large hotels and the service industry and also controlled many hotels through the state-owned *Compagnie Seychelloise de Promotion Hôtelière* (COSPROH). Not surprisingly, the private sector shrank, losing capacity to produce and compete as resources were diverted to state-driven activities.

At that time, copra, cinnamon, and vanilla were the main exports, and the Seychelles competitive edge was the price of its labor. Jobs were abundant. After 1977, however, as the state raised wages within the civil service and public enterprises, the labor advantage evaporated. Exports fell drastically and tourism became the principal source of hard currency.

The state viewed its investment in a new tuna cannery, managed by the parastatal *Conserverie de l'Océan Indien* (COI), as a way to mitigate the decline in traditional exports. But given the technology needs and the international competition in the tuna export industry, combined with COI's minimal marketing prowess, the cannery struggled to make ends meet and came to rely on state subsidies to survive. Many other state-driven enterprises also became dependent on subsidies. Nevertheless, per capita debt was still comparatively low.

Since the 1980s the government's commitment to building a comprehensive social service system and extensive infrastructure, with the support of forceful revenue mobilization, has been remarkable for a developing country (the 1981 revenue-to-GDP ratio was 41 percent). The government intervened heavily in the functioning of the financial system and borrowed extensively from banks, with the help of a restrictive foreign exchange system that ensured a captive market for government securities. In allocating foreign exchange, the government also gave precedence to its own programs.

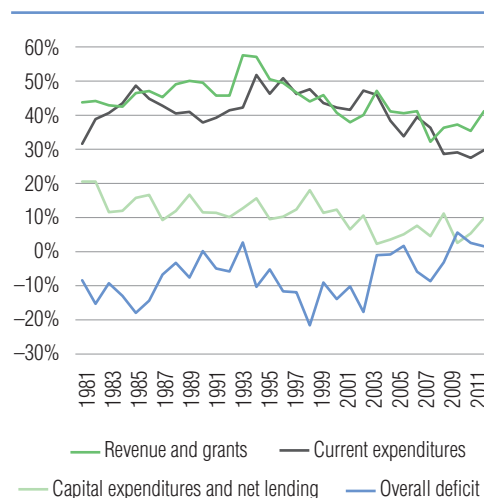
The dark clouds of the Cold War hung over Seychelles as the major powers jostled to take maximum advantage of its strategic location. The presence of a United States satellite tracking station at La Misère proved economically helpful; Seychelles benefitted not only from a direct U.S. contribution of some US\$8 million a year (enough to cover annual fuel imports) but also from spillovers from U.S. military personnel based on Mahé and their operations. Western governments, Eastern bloc countries, Cuba, and some Maghreb countries offered scholarships and concessional balance of payments support, loans, and grants, as well as from time to time supplies of military and related hardware. These relationships helped to offset the country's expanded spending; and low indebtedness at first allowed Seychelles to borrow to sustain its ambitious public investment program.

The decade from 1980 to 1990 was marked by the heavy influence of the central bank (which bankrolled large deficits), shortages of foreign exchange, and the consequent emergence of a parallel market for U.S. dollars. Although the 1990s saw some privatization, the system of importing and allocating foreign exchange continued to be restrictive until the mid-2000s, with essential imports in the hands of the Seychelles Marketing Board (SMB).

The economy grew rapidly from the mid-1980s through the 1990s, averaging 6 percent in the second half of the 1980s and 4.9 percent in the 1990s as tourism became established and the government embarked on ambitious infrastructure projects. During this period two public finance phases can be discerned (figures 1.1 and 1.2):

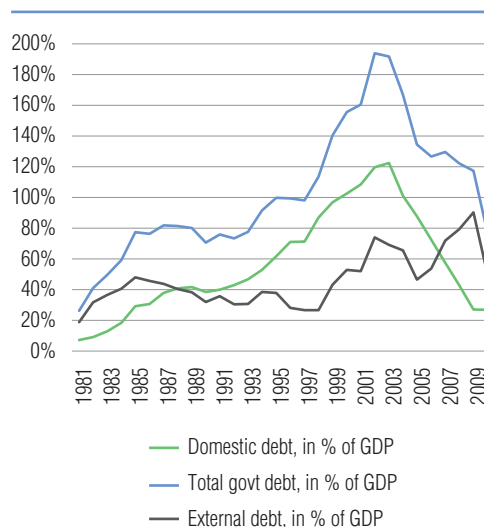
- Expansionism from 1982 through 1986.* Sluggish growth of government revenue, from 41 percent of GDP in 1981 to 46 percent in 1985, was accompanied by a surge in government spending from 51.5 percent of GDP to 64.3 percent. As a result, the deficit-GDP ratio rose from 8.8 percent in 1981 to 14.9 percent in 1986, financed mainly by borrowing from the banking system, and government domestic debt reached 30 percent of GDP. In this period, the government received substantial assistance from Eastern European countries and Cuba, especially in the social sectors (for instance, provision of medical staff).
- Relative restraint from 1987 through 1992.* During this period, the deficit plunge and in 1990 a small surplus was generated as expenditure and net lending declined from 52 percent of GDP in 1987 to 49.4 percent in 1990, while revenue and grants rose from 45.3 percent of GDP to 49.6 percent. In 1991–92, as spending rose only slightly, domestic debt stabilized at about 43 percent of GDP.

Figure 1.1 Revenue, Expenditure, and Fiscal balance, 1981–2011
(Percent of GDP)



Source: Ministry of Finance, IMF, and World Bank.

Figure 1.2 Government Domestic and External Debt, 1981–2010
(Percent of GDP)



Source: Ministry of Finance, IMF, and World Bank.

The 1990s: Early Warning of Structural Imbalances and Attempts at Private Sector Development

Precursors of Structural Imbalances

The Seychelles economic system ensured positive results for social indicators, which in the 1990s already far surpassed the average for sub-Saharan Africa (table 1). But excessive government spending and borrowing sent total public debt spiraling to unsustainable heights.

After the Cold War ended, in the early 1990s the effects of perestroika reverberating through Eastern Europe and the emerging world order left Seychelles vulnerable. Advances in technology made the U.S. satellite tracking base unnecessary, and the United States announced its withdrawal. Western aid dwindled and both cash and capital grants plunged. The winds of political change also swept through Seychelles, heralding a new era of multiparty politics. Government budgets, which were already in deficit, were further burdened in 1993 when Seychelles committed to hosting the Indian Ocean Games. This required investment in new sports infrastructure to the tune of nearly US\$30 million (nearly US\$400 per capita).

As assistance from both Western and Eastern blocs evaporated, instead of confronting the new reality Seychelles expanding its borrowing because of both growing requirements for hard currency and fiscal deficits—all omens of major

Table 1.1 Selected Social Indicators, Seychelles and Comparators, 2003

| | Seychelles | Sub-Saharan Africa | ECCU ^a | Barbados | Trinidad and Tobago | Mauritius |
|--|------------|--------------------|-------------------|----------|---------------------|-----------|
| Population (millions) | 0.1 | 704.7 | 0.6 | 0.3 | 1.4 | 1.2 |
| GDP per capita (US\$) | 8,404 | 505 | 5,609 | 10,000 | 8,603 | 4,588 |
| Net primary enrollment ratio (% of relevant age group) | 99 | — | 68 | 92 | 89 | 89 |
| Under-5 mortality rate (per 1,000) | 15 | 171.2 | 17.4 | 19 | 30 | 16 |
| UNDP HDI ^b ranking (out of 173 countries) | 36 | — | 73 | 47 | 62 | 77 |
| Life expectancy at birth (years) | 73 | 45 | 74 | 76 | 68 | 72 |

Source: IMF, World Bank, and UNDP.

^a ECCU = Eastern Caribbean Currency Union. Members are Antigua and Barbuda, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

^b United Nations Development Programme Human Development Index.

structural imbalances. Signs of strain in the supply of foreign currency began to appear. For the first time a black market for dollars emerged.

The Central Bank was still heavily influenced by the government, and the laws allowed the government to control monetary policy. The principal Secretary of the Ministry of Finance was also the governor of the Central Bank, a practice that persisted for several years. After the Cold War it was virtually impossible to keep government spending in check, and the Central Bank was bankrolling large deficits.

After 1992 Seychelles returned to an expansionary stance. Spending considerably exceeded revenue, and there was a dangerous buildup of debt, both external and domestic. The revenue ratio declined in 1995–98 to about 45 percent of GDP, while in 1994 spending reached 60 percent in response to the first multiparty elections in 1993 and the Island Games the same year. Spending went down in 1996–97 as revenue dropped because the U.S. satellite tracking station was closed. But spending was renewed in 1998–99, reaching an average of 65 percent of GDP owing to capital outlays for large investment projects, such as the East Coast Land Reclamation Project (ECP), roads, power generation, sewerage, water desalination, and water distribution, as well as housing.

The capital budget included grants to public enterprises like the Public Utility Company (PUC) and the Seychelles Public Transportation Company. After the mid-1990s, a significant part of the capital budget had also been allocated to land reclamation and housing. Cumulative costs of these projects from 1995 to 2008 averaged about US\$130 million, about 1 percent of GDP a year. Funding was assured by domestic budgetary resources.¹

Capital outlays, which had averaged 11 percent of GDP for 1990–94, reached 13.7 percent of GDP in 1998–2000, and current expenditure exceeded 45 percent of GDP as the civil service expanded. As a result, government deficits reached 11.6 percent of GDP in 1996 and 1997 and 22 percent in 1998, financed by a heady rise of government domestic debt, in the form of treasury securities purchased mainly by the banking system. Thus domestic government debt jumped from 45 percent of GDP in 1991 to 97 percent of GDP in 1999 (figure 1.2).

At that time the Seychelles rupee (SR) was pegged to a basket of currencies. This essentially entailed rate fixing, which inevitably (given recurring budget deficits) meant as a stopgap a run on the reserves and increased state borrowing. After 1992 expansionary fiscal policies weakened the balance of payments. The current account deficit exceeded long-term capital inflows, and the excess was financed by

¹ The land reclamation projects centered on Iles de la Providence and Ile Perseverance. The main capital projects of the 1990s and 2000s are analyzed in chapter 4.

drawing down reserves and accumulating arrears. Since the early 1990s, tourism receipts have accounted for 70–75 percent of national foreign exchange earnings.

Despite the increase in arrivals in the early 1990s, tourist receipts were limited by leakage into the emerging parallel market for foreign exchange. Throughout the 1990s the chronic shortage of foreign exchange increased the queue at commercial banks: Clearly worried about the deterioration in current accounts and about foreign exchange shortages, the government had instituted a new pipeline scheme in 1994. It required buyers of hard currency to queue at commercial banks until their demands could be met and deposit local currency against their requests. The system tied down precious capital for long periods, damming up business investments and cash flow. It did little to attract new investors, especially because repatriation of hard currency was by then seriously in question. By 1994, public finance pressures on the external position led to a very restrictive system of foreign exchange allocation that could not be alleviated, despite efforts from the late 1990s on to mobilize more foreign loans.

Private Sector Development

In the early 1990s there was a major expansion of economic sectors that earned foreign exchange, such as tourism and fisheries. As an alternative to addressing its monetary and exchange issues, the government started to offer incentives for private development, including privatization of some tourism and manufacturing activities. Private schools and clinics were also allowed. An ambitious policy was adopted to privatize government-controlled hotels and use appropriate incentives to attract new investment. Industrial fishing and processing increased with the 1991 opening of the Japanese-built quay in Mahé and expansion of the capacity of the tuna cannery (COI), which tripled production between 1987 and 1991 from 1,000 to 3,500 tons.

The government's strategic decision in the early 1990s to liberalize and privatize the hotel and tourism sector grew into a five-year tourism plan designed in 1993–95 to revamp the image of Seychelles tourism and increase annual arrivals. The first step was the 1991 reorganization of COSPROH, the state-owned hotelier, as a holding company comprising 14 subsidiaries, which each owned a hotel. The second was for COSPROH to withdraw from the management of larger, less profitable hotels, offering them on long-term leases to private management companies. In 1992, Le Meridien Hotels took over management of the Fisherman's Cove (48 rooms) and the Barbaron Beach (122 rooms) on Mahé. Similarly, the Reef Hotel (150 rooms), the Côte d'Or Lodge (38 rooms), and the Northolme Hotel (19 rooms) were leased

to private hotel management companies. The management companies were both local and foreign. In 1993 COSPROH entered the third phase of liberalization. Three large hotels—the Mahé Beach (173 rooms), the Beau Vallon Beach (183 rooms), and the Praslin Beach (173 rooms)—were acquired by the Malaysian Berjaya Hotels Group, which assumed full ownership of the first two and a 20 percent share of the third. Since the early 1990s COSPROH had reduced its share of hotel room capacity from about 60 percent to 20 percent.

The five-year tourism plan also sought to maximize foreign exchange earnings by increasing yearly tourist arrivals from 100,000 to about 250,000, while keeping in mind Seychelles' environmental limits. One instrument of the policy was an independent Tourism Promotion Board. Established in early 1995, the board had representatives from hotels, tour operators, car hire agencies, and other tourism-related businesses. Its objective was to promote Seychelles as a tourist destination for a wider range of consumers, not just high-end. The new tourism policy was supported by tax incentives. The 1994 Tourism Promotion Act granted a number of tax concessions and allowed hotels and tourism operators to retain more foreign exchange.

In an attempt to diversify the economy and relieve the clearly worsening economic situation, in 1994 a new offshore financial services sector was born. Seychelles International Business Authority, a new government-controlled body, was appointed regulator. Laws were passed allowing for registration of international business companies and trusts and licensing of free-port companies geared to export markets. These businesses were exempt from exchange controls and virtually tax-free.

These measures had some success. Reduced taxes and favorable long-term options for repatriating hard currency attracted new investors. Financial services grew rapidly as offshore companies domiciled in the Seychelles. But domestic shortages were still not resolved.

In 1996, the Investment Promotion Act was passed to attract new capital. Geared especially to foreign investors in tourism, it offered a series of concessions, such as exemption from import taxes, and reduced business tax rates and contributions on wages. It also gave some leeway on exchange controls in that companies with an Investment Promotion Act certificate of approval could retain some hard currency at levels approved by the authorities. The act resulted in a two-tiered system—companies that earned hard currency and those that did not. Again the results were marginal. Severe shortages of hard currency persisted.

The tuna cannery was again expanded after U. S. conglomerate H. J. Heinz in 1994 acquired a 60 percent stake in it, with the government holding the minority

stake. The cannery was renamed Indian Ocean Tuna, Ltd., and production expanded substantially, from 45 tons a day in 1994 (12,400 tons a year) to 170 tons a day by mid-1998 and 230 by mid-1999. The number of foreign vessels licensed to fish in Seychelles waters had reached 50 by the mid-1990s; most were European but some were Russian and East Asian.

Late 1990s to Early 2000s: Borrowing from Abroad and Thinking about Reform

Expansionary Fiscal Policies and Exchange Tightening

The surge of government investment in the second half of the 1990s markedly affected GDP, which grew on average by 11 percent in 1996 and 1997, a time when private investment was also buoyant. GDP growth then slowed to 2.1 percent on average in 1998 and 1999 but reversed to 4.2 percent in 2000. Growth rose in the mid-1990s, in conjunction with a resurgence in the investment ratio, which exceeded 30 percent for 1993–98, and then declined in the early 2000s, when both private and public investment dampened.

The expansionary fiscal stance of the 1990s brought on major balance of payment difficulties and severe shortages of foreign exchange, which were addressed by restrictive regulations on the purchase of foreign exchange in 1994 (the pipeline system) and a complex system of surrender requirements and priority allocations in 1995 (see chapter 4 for details). Expansionary policies were funded by bank financing, which absorbed the bulk of loanable bank funds.

The foreign exchange system was based on the principle that all foreign exchange earners had to surrender a large part of those earnings to commercial banks, which in turn had to surrender 45 percent to the Central Bank for imports of essential goods by the SMB, government debt servicing, and airlines servicing Seychelles.² Initially major foreign exchange earners could retain 25 percent of their earnings, but this was cut to 20 percent in January 1997 and then to 15 percent in 2000. Banks also had to allocate 10 percent of receipts to clear arrears in a “frozen pipeline.” Banks could use only

² By 2000, the Central Bank was using proceeds of the 45 percent surrender requirement as follows: 27 percent was allocated to SMB for essential imports, 13 percent was destined to meet the government’s external debt service requirement, and 5 percent was transferred to non-resident airlines servicing Seychelles. In addition banks had to sell 2.5 percent of their foreign exchange earnings to the Seychelles Tourist Board for its foreign promotion activities.

the remaining foreign exchange (35–40 percent) to meet customer demands, based on specified priorities.³

Exchange restrictions were joined in 1998 by trade restrictions to limit imports of goods and services. Import permits had to be requested for each shipment of commodities, and import quotas—set at a percentage of the previous year’s imports—continued. The new rules banned imports of second-hand vehicles and reduced the number of expatriate workers in order to limit foreign exchange outflows related to employee compensation.

Tighter restrictions on trade and foreign exchange did not attenuate foreign exchange tensions because ambitious national construction projects in 1998–99 had high import requirements. The government pursued the Victoria Modernization and Expansion project, the ECP, the airport in Praslin, the highway to the Mahé airport, expansion of the PUC power plant, and the Victoria sewage treatment plant. At the same time, the private sector made substantial investments, financed with capital inflows, in expansion of the tuna cannery, construction of the Orion Mall business and retail complex, and construction of luxury hotels, including the Lemuria Hotel in Praslin and others on the outer islands.

The stable nominal exchange rate against the US dollar in 1994–99 caused the rupee to appreciate significantly in relation to currencies of nearby countries that were also tourist destinations, such as Kenya (19 percent), Mauritius (33 percent), and South Africa (63 percent). Between 1994 and 1999, external arrears rose to US\$54 million, while gross Central Bank official reserves held steady at about US\$30 million, which corresponded to less than one month of imports.

To stem the growth of the parallel market in foreign currency that had sprung up in the mid-1990s, in April 1999 an amendment to the Foreign Exchange Regulation Act, 1996, required tourists to settle bills in foreign exchange, and an amendment to the Exchange Control Act made it illegal for residents to possess foreign exchange not obtained through the banking system.

To attract investment in tourism despite the exchange restrictions, the government granted foreign investors very attractive tax conditions. The Investment Promotion Act of 1994, followed by the Tourism (Incentives) Act of 2003, provided such incentives as long tax holidays, accelerated depreciation of 150 percent for expenditures on buildings and equipment, and exemptions from trade taxes, fuel taxes, and the goods and service tax (GST). Investors were allowed to retain part of the foreign exchange earned. These incentives achieved

³ It is estimated that by 2000 the unsatisfied demand for foreign exchange ranged between US\$ 50 million and US\$ 150 million.

their objectives: investment in hotels averaged US\$40 million a year for 1996–2000 and exceeded US\$50 million a year in 2000–04.

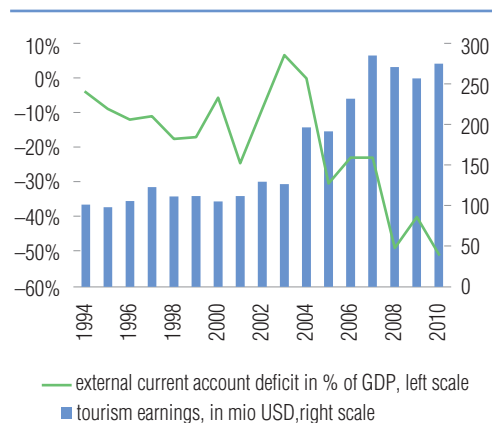
Because of the rapid increase in imports, the current account deficit rose from 11 percent of GDP on average in 1995–97 to 18 percent in 1998–2001, with a peak of 30 percent in 2001 owing to the long-term lease of aircraft by Air Seychelles. The deficit only partly reflected a rise in foreign direct investment (FDI). But because tourism earnings through the banking system were stationary, partly because of the exchange restrictions, pressures on official reserves persisted and external arrears rose significantly (see figures 1.3 and 1.4).

Debt Accumulation and Borrowing on the Capital Market to Refinance

By the mid-1990s all official international creditors had suspended lending to Seychelles. At that time, the government was confronting two challenges: paying for spending it wanted to do, and managing an increasingly difficult foreign exchange situation, which was the consequence partly of fiscal policy and partly reluctance to let the exchange rate adjust to a market-determined level.

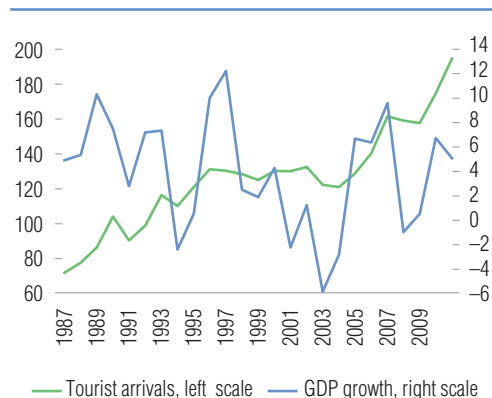
The authorities then ventured into a new financing arena—commercial borrowing on the international money market. A first syndicated bond of US\$30 million was issued in 1998 with Citibank, generating much local publicity. As expected, given the country's precarious economic state, fees and interest charges were high and the tenure short-term.

Figure 1.3 Tourism Earnings and Current Account Deficit, 1994–2010



Source: National Bureau of Statistics, Ministry of Finance, and Central Bank of Seychelles.

Figure 1.4 Tourist Arrivals (000s) and GDP Growth Rate (%), 1987–2010



Source: National Bureau of Statistics, Ministry of Finance, and Central Bank of Seychelles.

Problems with hard currency supply and demand were intensifying because in mid-1998 the country had embarked on a massive US\$75 million reclamation project, ECP Phase III, in mid-1998. The project sought to reclaim almost 360 hectares off the eastern coast of Mahé, the main island, and create over 3 million cubic meters of coral fill. The coral fill was to be used primarily in construction and backfilling, which had previously relied on the environmentally detrimental extraction of beach sand. The reclaimed land was designated for port development, industrial fishing, and other commercial uses, including waterfront development. The injection of cash from the \$30 million loan syndicated with Citibank alleviated some of the short-term demand for hard currency, but the high cost of servicing the loans quickly diluted their benefit, and it became necessary to refinance. ABN AMRO organized a second bond issue in early 2000 to repay the first, and a few years later there was a third, through the Bank of Tokyo–Mitsubishi. Each refinancing transaction was larger than the previous one.

The government was trapped in a debt-arrears cycle in which unpaid debt led to accumulated unpaid interest, and the arrears caused more arrears. By 1999–2001 net credit to government accounted for nearly 85 percent of domestic credit from the banking system, leading to rapid growth of the money supply (12 percent a year) and a rise in consumer price inflation to 6 percent after stable prices in 1994–98.⁴ Government funding by the banking system was secured via the loan asset ratio (LAR) requirement, which forced banks to invest a set part of their assets in government securities. To encourage mortgage lending, the LAR was reduced from 70 percent to 50 percent in August 2001.⁵

By the end of 2001, public external debt had reached the equivalent of US\$320 million, 50 percent of GDP, including arrears on debt and other items of about US\$54 million, 9 percent of GDP (figures 1.5 and 1.6). Of this, US\$15 million was owed to multilateral creditors, US\$33 million to bilateral creditors, and US\$6 million to commercial creditors (table 1.2). Substantial arrears to the private sector compounded the problem because of the impediments erected by the foreign exchange allocation system, with its limitations on the repatriation of dividends and management fees.

To limit the accumulation of arrears, in 2001 the authorities again tightened foreign exchange restrictions. They required permits for all imports, heightened monitoring to detect over- and under-invoicing of imports, and increased control

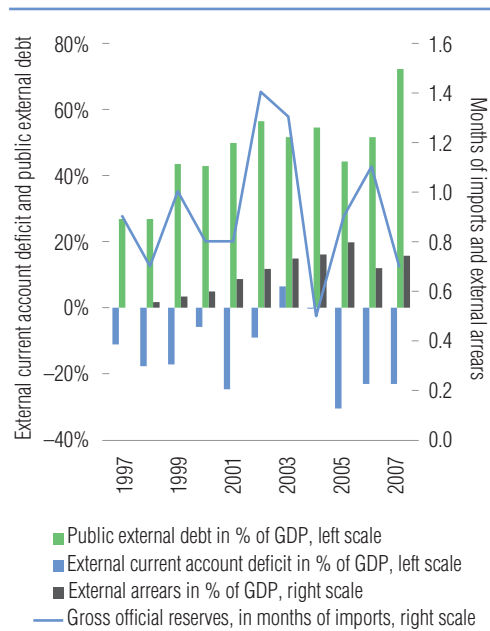
⁴ Annual year-on-year rates were 1.8, -0.3, -1.1, and 2.7 percent for 1994–98, after which they jumped above 6 percent for the next three years.

⁵ The LAR was raised again to 65 percent in August 2006 to absorb a liquidity buildup.

over hotels receiving and depositing foreign exchange in the banking system. Rules on bank allocation of foreign exchange for 10 categories of imports were tightened, and banks were not allowed to use foreign exchange for customer claims predating June 2000. Even though it kept 45 percent of all foreign exchange surrendered, the Central Bank had trouble meeting the government foreign exchange requirement for debt service and the extensive public works program. In November 2001, the decision to allocate to each citizen US\$300 in foreign exchange for travel abroad further limited what was available for private imports. As a result, many of them began to be financed from accounts held abroad, while consumers increasingly shopped abroad rather than using domestic retailers.⁶

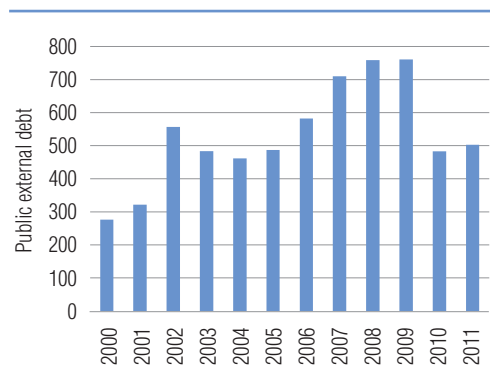
Despite these measures, as shortfalls of foreign exchange mounted, arrears continued to accumulate on public debt and on what was owed to private suppliers. Foreign exchange receipts in the next few years continued to be inadequate to service external debt, so that by the end of 2005 external arrears had risen from the equivalent of US\$54 million to US\$184 million, 25 percent of GDP. To limit the

Figure 1.5 External Indicators, 1997–07
(Months of Imports)



Source: Ministry of Finance.

Figure 1.6 Public External Debt, 2000–11
(US\$ millions)



Source: Ministry of Finance.

⁶ The new foreign exchange regulations strengthened the position of the SMB in relation to the private sector. The allocation system in effect after June 2001 enabled it to obtain foreign exchange both from the Central Bank (for imports of essential goods) and from many categories instituted for the banks. This advantage allowed SMB to expand its new manufacturing operations, displacing competitors.

Table 1.2 External Government Arrears (US\$ millions)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|-------------------------------------|------|------|-------|-------|-------|--------|--------|-------|
| Total arrears | 53.9 | 81.4 | 104.1 | 136.6 | 184.2 | 123.5 | 162.5 | 316.7 |
| Multilateral creditors | 13.1 | 25.2 | 33.3 | 39.6 | 57.7 | 0.3 | 3.0 | 0.0 |
| African Development Bank | 10.0 | 20.2 | 27.3 | 30.9 | 48.9 | | | |
| World Bank | 0.0 | 0.5 | 0.8 | 1.5 | 0.9 | | | |
| Others | 3.2 | 4.5 | 5.2 | 7.2 | 7.9 | 6.6 | | |
| Bilateral creditors | 34.2 | 50.1 | 56.8 | 79.8 | 103.5 | 103.8 | 134.9 | 178.8 |
| Paris Club | 33.2 | 46.7 | 49.5 | 67.9 | 79.6 | 100.2 | 119.8 | 121.8 |
| Others | 1.0 | 3.4 | 7.3 | 11.9 | 23.9 | 3.6 | 15.1 | 56.9 |
| Commercial creditors | 6.2 | 6.1 | 14 | 17.1 | 22.9 | 19.4 | 24.6 | 137.9 |
| Banks | | | | | | 19.4 | 24.6 | 15.6 |
| Securities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 122.3 |
| External debt to GDP (%) | 48.7 | 51.9 | 52.4 | 54.3 | 44.0 | 51.4 | 71.9 | 79.2 |
| <i>Of which: Arrears to GDP (%)</i> | 8.6 | 11.7 | 14.8 | 19.5 | 25.5 | 14.8 | 14.8 | 14.8 |
| Nominal GDP (US\$ millions) | | | | | | 1037.6 | 1038.8 | 957.6 |

Source: IMF Staff Reports.

growth of external arrears, starting in 1998 the Central Bank turned to commercial loans, the terms of which gradually became more onerous. Lenders required that part of government and Central Bank foreign exchange earnings be deposited in blocked escrow accounts controlled by the creditor banks.

Attempts to Relax Exchange Restrictions

There were reforms and adjustments in the early 2000s, but they were only partial. A purely fiscal reform did not address distortions and constraints in the real sector. The monetary system could not adjust to the imbalances because they were driven by restrictive policies imposed largely through the government. Inflation was also measured at artificial prices—the real prices people paid through the black market were not properly accounted for. The incomplete reform program was unsuccessful.

Gradually the authorities came to recognize the severe adverse effects of foreign exchange controls and rationing. The downturn of GDP from 2000 to 2003 was abrupt, and while the reduction in tourist arrivals after September 2001 contributed to the GDP decline, economic activity was hemmed in by the foreign exchange shortages and restrictions. The authorities became convinced of the need

to significantly tighten the fiscal stance as a move toward relaxing exchange restrictions and stimulating private activity.

The government attempted to secure support from the IMF, the World Bank, and the African Development Bank. The program⁷ discussed included an exchange rate adjustment toward the parallel market indicative rate in the form of a crawling peg, along with fiscal tightening and structural measures, such as downsizing the public sector. Preparations for a program were advanced and a final draft of a Memorandum of Economic and Financial Policies had been prepared for signature in the second quarter of 2001. Discussions were protracted and at times difficult. The authorities alternately recognized the need for fundamental reform and feared the inflationary impact of devaluation.

By July 2001 the authorities had abandoned plans for reform and reintroduced exchange controls. The full-blown exchange control regime involved, in addition to the pipeline, a three-pronged approach that regulated new foreign earnings, imports, and banking. Each prong was managed by a “controller,” and all were supervised by a powerful committee headed by the economic advisor to the president of the Republic.

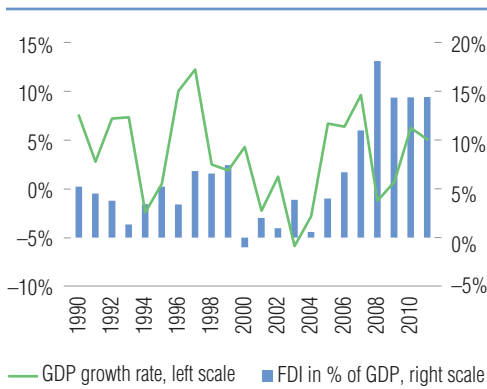
A special Foreign Earnings Regulations Division was created in the Central Bank to focus on the unprecedented level of currency controls, which proved both highly bureaucratic and very difficult to implement. Once again, the results were limited. Although more hard currency entered the banking system, it was still not enough to meet national demand. The Central Bank’s controls on banks had only minimal impact. Unofficial transactions on the flourishing black market had become the norm rather than the exception. The black market prevailed; shortages persisted.

Tax and exchange concessions facilitated major new investments in tourism in the early 2000s. They included construction of the Lemuria Hotel in Praslin and of major hotels on Mahé, such as the Four Seasons at Anse Soleil, the Plantation in Baie Lazar, and Banyan Tree at Intendance. Although hotel capacity increased, tourism earnings through official banking channels rose only slowly, from US\$100 million in 1994 to US\$111 million in 2001 (figure 1.5).⁸ In 2001, growth turned negative (figures 1.6 and 1.7). Modest growth of 1 percent was achieved in 2002 (figure 1.8), but a deep economic downturn that began in 2003 continued in 2004 as Seychelles became less competitive as a tourist destination. The fixed exchange rate and extensive exchange rate restrictions made the country less attractive to visitors.

⁷ The proposed program did not differ significantly from the one Seychelles eventually implemented, successfully, in 2008.

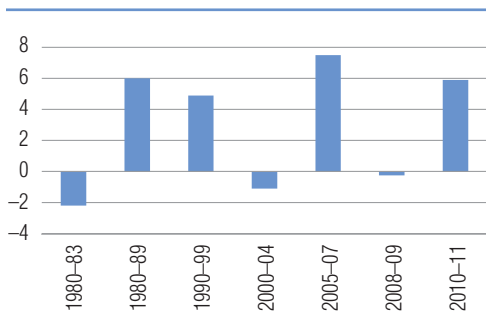
⁸ Only after 2003 did they start rising significantly, exceeding US\$200 million, when a second wave of new hotels came on stream (discussed later). Tourist arrivals increased from about 130,000 a year in 1996–2005 to 160,000 in 2007–09; in 2011, with the opening of more new hotels, arrivals reached 194,000.

Figure 1.7 Foreign Direct Investment and GDP Growth (%), 1990–2011



Source: National Bureau of Statistics, Ministry of Finance, and Central Bank of Seychelles

Figure 1.8 Average Real GDP Growth (%), 1980–2011



Source: National Bureau of Statistics

The pressure the expansionary fiscal stance was exerting on the balance of payments, and the worrisome accumulation of total government debt (200 percent of GDP by 2002, about one-third of it external debt), prompted preparation of the Macroeconomic Reform Program and extensive consultation with the IMF. The program centered on a tight compression of government spending over the next three years (a cut equivalent to 11 percent of GDP), accompanied by the introduction in mid-2003 of a broad-based GST. In addition to fiscal measures, the program included adoption of the 2003 Tourism (Incentives) Act.

The GST imposed a turnover tax on specific tourism businesses.⁹ The GST was also applied at the retail level on some manufactured products and at the point of entry on imported goods. An important element of its success was that it did not allow for discretionary exemptions, unlike practices related to the trades tax, another import-related law. These measures did help to bring down the deficit but were

⁹ The GST is applied at varying rates of 10, 12, and 15 percent on specific goods manufactured in Seychelles, imported goods, and services. For tobacco, alcohol, and petroleum products, the tax is applied at a specified rates. The 15 percent rate applies to professional services, telecommunications, insurance, and rental income. The rate on tourism services was set initially at 7 percent and was raised in January 2009 to 10 percent, and in November 2010 to 12 percent. GST on imported goods was set at 12 percent; imports of capital equipment, construction goods, and goods for the water and electricity sector, for educational and medical institutions, and the medical sector were exempt. The base for the GST was somewhat narrow, as all sectors not specified as taxable were exempt, including activities of the construction sector, financial service fees and commissions, property and casualty insurance, water and electricity, and public transport. A discussion of the GST structure and limitations and the need for reforms is presented in Chapter 6.

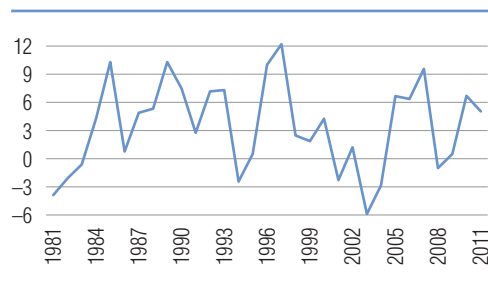
not sufficient to increase confidence or bring about a turnaround in other economic fundamentals. The revenue measure raised tax receipts by 7 percent of GDP, which, together with expenditure restraint, made it possible to achieve the ambitious target of a surplus of 1.4 percent of GDP, which implied an adjustment of about 20 percent of GDP between 2002 and 2003.

The abrupt budgetary adjustment helped to reduce the external current account deficit from 12 percent in 2001 to near balance in 2003 and it stabilized the public debt-to-GDP ratio—though at 200 percent it was still among the highest in the world. Tourism earnings picked up significantly in 2004–05 as exchange restrictions were relaxed. However, the spending cuts could not be sustained; they were not accompanied by an adjustment of the overvalued exchange rate. The overvalued rupee, the import restrictions, and a decline in public investment slowed economic activity; real GDP fell by 6.3 percent in 2003 and 2 percent in 2004. However, inflation plunged.

The fiscal tightening succeeded in reducing domestic debt as a share of GDP from 135 percent in 2002 to 65 percent in 2007. Despite the fiscal tightening, arrears on external public debt kept accumulating, reaching the equivalent of US\$185 million by the end of 2005, up from US\$136 million a year earlier. Of this US\$30 million was owed to the African Development Bank, US\$1.5 million to the World Bank, and US\$75 million to bilateral creditors (table 1.2). The exchange rate had been stable in relation to the US dollar since February 2003, which led to a steady depreciation against the euro and a depreciation of 15 percent of the real effective exchange rate. While this benefited the tourism sector, it did not offset the competitiveness Seychelles had lost to other tourist destinations in previous years. The tightening of public finances in 2003 led to a slowdown in imports and a modest rise in gross official reserves, which reached the equivalent of 4.7 weeks of imports at the end of 2005, up from 3.7 weeks a year earlier.

By 2005, the authorities were more or less resigned to the fact that it was virtually impossible to fight the black market. The state was finding it difficult to meet its daily obligations. The reform program was widened to encompass measures for relaxing the price, trade, and exchange restrictions that were impeding growth. Specifically, prices of food products were liberalized, and a tender system

Figure 1.9 Real GDP Growth (%), 1980–2011



Source: National Bureau of Statistics

for imports of essential goods was introduced, replacing the SMB monopoly. Import licenses were removed early in 2005, and in December 2005 trade taxes on all raw materials, specified capital equipment, and a range of consumer products were reduced to zero.

Recurrent expenditures were significantly higher as a ratio to GDP than in comparable middle-income countries, such as Mauritius (table 1.3). While public expenditures increased across countries as per capita GDP rose, according to the World Bank between 2000 and 2005 public expenditure in Seychelles was about 20 percent higher than could be justified by per capita income.¹⁰ The relatively high level of expenditure is explained by a fairly generous welfare system and transfers to public enterprises (table 1.3). Spending on education, health, housing, defense, and security was quite stable (table 1.4). Spending on health and education as a percentage of GDP was in line with that of comparator countries.¹¹ Transfers for the operation of independent public agencies fulfilling regulatory, social, developmental, and communication functions absorbed 2.6 percent of GDP in 2006 and 3.7 percent in 2007.

The investment code adopted at the end of 2005 conformed to best practices and provided for a unified legal framework. It guaranteed repatriation of foreign

Table 1.3 Public Spending, Seychelles and Comparators (Average 2000–05)

| Country | Government Recurrent Spending (% of GDP) | Percent of Spending on | | | |
|----------------------|--|-------------------------|-----------------------|--------------------|-------------|
| | | Subsidies and Transfers | Employee Compensation | Goods and Services | Interest |
| Barbados | 21.1 | 18.5 | 43.0 | 16.5 | 14.0 |
| Estonia | 24.3 | 43.7 | 21.3 | 17.3 | 0.0 |
| Fiji | 26.7 | 22.5 | 43.0 | 16.0 | 10.0 |
| Maldives | 33.3 | 3.0 | 24.8 | 67.5 | 5.0 |
| Mauritius | 28.2 | 33.0 | 38.8 | 12.8 | 13.0 |
| Seychelles | 36.1 | 29.8 | 29.3 | 21.5 | 15.3 |
| Trinidad and Tobago | 36.6 | 31.7 | 36.0 | 16.0 | 15.3 |
| Group average | 29.5 | 26.0 | 33.7 | 23.9 | 10.4 |

Source: World Bank, Seychelles Public Expenditure Review, 2009.

¹⁰ World Bank, Public Expenditure Review, 2009.

¹¹ Spending on education as a percentage of GDP in Seychelles in the 2000s was close to that in South Africa, Morocco, and Ukraine (about 5 percent). Spending in the health was comparable to Mauritius, Morocco, and Peru.

Table 1.4 Spending by Function (% of GDP), 2002–07

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|-----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| General public services | 14.4 | 14.9 | 12.1 | 12.4 | 9.8 | 8.4 |
| Defense | 2.4 | 2.5 | 2.7 | 1.5 | 1.9 | 2.6 |
| Public order and safety | 2.5 | 2.9 | 2.6 | 1.9 | 2.3 | 3.2 |
| Economic affairs | 5.1 | 4.6 | 4.7 | 2.1 | 3.1 | 4.8 |
| Housing and community amenities | 1.7 | 0.7 | 0.5 | 0.4 | 1.0 | 1.6 |
| Health | 4.2 | 5.9 | 5.3 | 3.9 | 3.9 | 4.7 |
| Recreation, culture, and religion | 0.8 | 2.6 | 1.8 | 1.2 | 1.7 | 1.2 |
| Education | 6.6 | 6.0 | 5.0 | 3.6 | 4.3 | 6.5 |
| Social protection | 9.4 | 8.1 | 7.2 | 6.5 | 14.8 | 6.7 |
| Unallocated | 10.7 | 0.0 | 0.0 | 5.4 | 4.3 | 1.2 |
| Total | 57.7 | 48.2 | 41.9 | 38.9 | 47.0 | 40.9 |

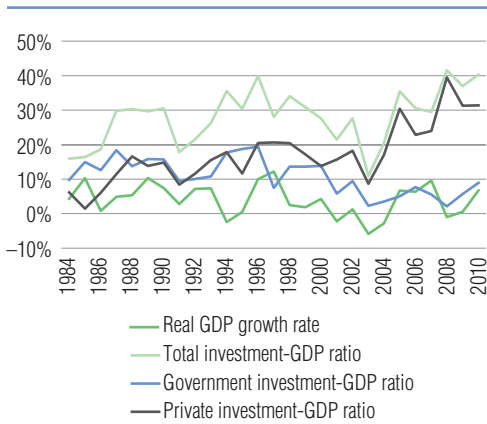
Source: World Bank, Public Expenditure Review, 2009, and Government of Seychelles.

income and the right to convert earnings in local currency to foreign currency, but in practice such transactions still had to be carried out through the pipeline. Although the state had begun to relinquish some of its commercial activities, there was still pent-up demand for hard currency. The state was accumulating arrears in financing recurrent needs as well as long-term debts. Multilateral institutions still would not provide long-term loans, and traditionally receptive countries were reluctant to lend to Seychelles, either because of the risks associated with any new lending or because of their own economic problems.

Although by then the state as borrower undoubtedly had little if any credibility, the international market somehow reacted positively to what would now be considered potentially toxic financing. The market may have been responding to a very flattering rating by Standard and Poor's, issued despite the fact that all economic fundamentals pointed to serious imbalances in the Seychelles economy and augured disaster if there were no major adjustment program. At this point, national debt had assumed alarming proportions. Reserves of hard currency had been drawn down to only weeks of imports, and Seychelles was finding it virtually impossible to access credit.

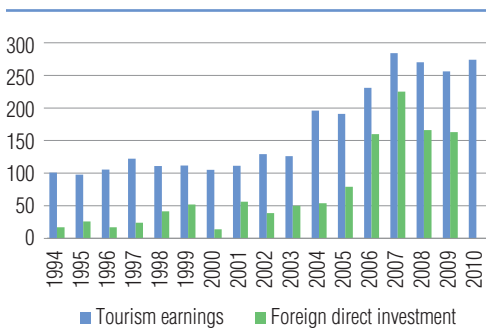
The fiscal adjustment was largely reversed in 2006, leading to significant deficits, and public debt did not decline at all in 2006 and 2007. In 2006, the authorities launched yet another bond, this one for US\$200 million, payable in a single balloon payment in year five (2011). The interest coupon was 9.125 percent. Lehman Brothers arranged the bond issue. Another US\$30 million bond

Figure 1.10 Real GDP Growth and the Investment/GDP Ratio, 1984–2010 (Percent)



Source: National Bureau of Statistics, Ministry of Finance, and Central Bank of Seychelles.

Figure 1.11 Tourism Earnings and Foreign Direct Investment, 1994–2010 (US\$ millions)



Source: Ministry of Finance, Central Bank of Seychelles.

issue followed in August 2007, and then a separate issue for €55 million. Seychelles' finances were thus extremely vulnerable to the external shock of 2008, when oil prices tripled, external reserves were almost non-existent, and scheduled debt service was high.^{12,13}

In 2005–07, the completion of large new hotels revived tourist arrivals and caused growth to pick up significantly (7.5 percent on average in those three years). General growth resumed only in 2005, after two years of recession, and lasted for three years, with average growth of 7.5 percent. The strengthening economy was again related to an uptick in investment, by the government in infrastructure and the private sector in hotel construction (figure 10; see also chapter 3). Tourist arrivals are also correlated with growth. Growth years 1996–97 were marked by a new peak in tourist arrivals, at 130,000 per year. Arrivals stabilized until 2005 and then grow again in 2007–09, when they reached 160,000 a year, with the corresponding earnings contributing to higher GDP growth in 2006–07 (figures 1.10 and 1.11).

¹² While external debt was stable between 1990 and 1998—close to 30 percent of GDP—it soared in 1999 and 2000 and then again in 2002, reaching 74 percent of GDP by the end of 2002 (see figure 2). After declining in 2003–05, external debt raced up again in 2007–08 to 84 percent of GDP, when bond issues were placed on international markets. By mid-2008, the external oil price shock forced the government to request a debt moratorium followed by comprehensive debt relief.

¹³ Comprehensive foreign exchange liberalization started only in 2004–05, but foreign exchange restrictions were maintained until the regime was completely liberalized at the end of 2008.

Late 2000s: External Borrowing Depletes the Economy

In 2006 and 2007 a resurgence of tourism receipts resulted from the completion of additional hotels and the increased availability of foreign exchange, enabling the government and the private sector to repay about US\$70 million of external arrears and to relax exchange restrictions. Tourism earnings jumped from US\$191 million in 2005 to US\$284 million in 2007 with the opening of the Four Seasons and the Eden Island resort complex, among others. A Eurobond issue for US\$200 million launched in 2006 allowed the Central Bank to repay previous debts and increase gross official reserves. In two years (2005 and 2006), gross reserves rose by US\$76 million to US\$111 million, the equivalent of 1.1 months of imports, up from 0.4 months at the end of 2004.

To reinforce their medium-term strategy, in 2007 the authorities launched the medium-term development plan, *Seychelles Strategy for 2017*, with the objectives of doubling per capita income and reducing public debt to 60 percent of GDP. Reflecting a gain in confidence, in late 2007 the government issued a private placement note for €54.7 million and a US\$30 million supplement to the Eurobond to pay for clearing a backlog of unremitted profits by foreign investors. In order to move gradually toward a less restrictive foreign exchange system, the authorities let the rupee depreciate 45 percent, from SR 5.5 to US\$1 at the end of 2005 to SR 8 at the end of 2007. The combination of new external borrowing and depreciation of the exchange rate brought public external debt to US\$720 million, 72 percent of GDP, in 2007, up from US\$487 million, 47 percent of GDP at the end of 2005 (see figures 1.5 and 1.6).

Despite some improvement, the external situation was still very tenuous. The global economic crisis of 2008 exacerbated the economic imbalances accumulated in the years before. The external position worsened over 2006–08, first as a result of rising global energy and food prices and then when the global crisis weakened Seychelles tourism in late 2008.¹⁴ The external deficit widened to 20.3 percent of GDP. Foreign exchange resources were rapidly being exhausted and shortages again became the norm. A number of state-owned enterprises were operating well below efficiency, and foreign exchange reserves fell to less than one month of imports. By late 2008 the government was unable to honor a coupon payment on a US\$230 million bond. Growth in GDP plunged, from 9.9 percent of GDP in 2007 to –1.0 percent in 2008.

In October 2008 the authorities announced that they would approach external creditors to seek agreement on comprehensive restructuring of the debt,

¹⁴ Tourism earnings fell by 15 percent in 2009.

which by the end of 2008 amounted to US\$800 million, equivalent to 87 percent of GDP, of which 42 percent (US\$333 million) was in arrears. In mid-2008 the government had initiated discussions with the IMF and multilateral institutions like the World Bank to develop a homegrown reform program. The next chapter discusses this bold economic restructuring program and its impact on the Seychelles economy.

2

The 2008 Reform Plan in the Making

By the end of 2006, queues could often be seen at banks as people sought to purchase hard currency. Shops ran short on basic items, including food, because overseas suppliers had not been paid. Local manufacturers were unable to produce effectively because they could not pay for raw materials. Although fuel never ran short, payments to suppliers had become irregular, and sometimes suppliers almost missed critical delivery dates. The government hospital, which often sent medical cases overseas for specialized treatment, was failing to pay its bills, and foreign medical centers were threatening to stop receiving its patients. In domestic hospitals, delays in paying drug suppliers created shortages or total stock-outs of critical medical supplies. The education sector fared equally poorly.

The situation was rapidly becoming untenable, and the Ministry of Finance desperately needed new solutions. The financial credibility of the government was at an all-time low. Senior government figures and even executives in the private sector fought daily to obtain hard currency to cover the rising costs of imported fuel and food and meet Seychelles' basic needs. International suppliers now insisted on cash payments before delivery; they would not accept letters of credit drawn on local banks.

The Decision to Restructure

By 2007 a new Minister of Finance and Trade, Danny Faure, and a new Principal Secretary of Finance and Trade, Ahmed Afif, had put together a dynamic team, which, with support from the IMF, was determined to address the challenges facing Seychelles. The team began to plan one of the most fundamental economic reforms Seychelles had seen in more than two decades.

In mid-2008, as major international financial institutions were bankrupted and a protracted world recession began, the Government of Seychelles was forced to look for alternative strategies to put the economy right. Currency controls and state intervention had clearly failed. It was also clear that Seychelles would get no new aid unless a serious, credible reform, backed by local and international parties, was enacted to address the fundamental imbalances in the economy.

Discussions thus began in earnest on an IMF-supported reform strategy for an all-encompassing reform program that would leave nothing undone to reverse the free fall of the Seychelles economy. Soon after, Seychelles had discussions with other institutions, like the World Bank and the African Development Bank, about support for the program.

Reengineering the Economy: Policy Options and Political Challenges

At that economic crossroads for Seychelles, a number of facts were evident:

- Any solution would have to feature a devaluation. The black market was paying a 50 percent premium on the U.S. dollar.
- Price controls were ineffective, and market-driven mechanisms were needed to replace state controls and monopolies.
- Imports and trade needed to be liberalized so that competition would thrive and keep prices in check.
- A serious effort was needed to eliminate budget deficits by, e.g., improving receipts, attracting new receipts, privatizing state-owned enterprises, eliminating universal subsidies, and reforming the civil service and its methods of operation. Public enterprises that might burden the public debt by requiring additional government financing had to be overhauled.
- It was vital to reevaluate how Seychelles' natural resources, especially its marine resources, were being exploited and determine whether Seychelles could improve its trading relationships.

The Ministry of Finance championed the reform program and identified, with the assistance of the IMF, the immediate priorities:

- Restore confidence in the economy by removing currency and price controls and allowing market forces to drive trading and other economic activity.
- Reverse budget deficits and create a surplus, primarily to repay accumulated debt.

- Restore confidence in Seychelles overseas by clearing both private and commercial arrears and especially by reducing its external indebtedness.

Politically, all of these actions had serious implications: (1) Another failed economic reform would be catastrophic. (2) Politicians needed to be ready for the reaction to a number of major decisions, such as devaluation, which had previously been touted as inappropriate or unsuitable for a small island economy. (3) The removal of price and import controls and of trade restrictions could also be seen as a failure of past policies that had been adopted to protect poorer citizens. A major concern was to reassure the poor that they would not be abandoned as reforms proceeded. Another concern was that elimination or reduction of inefficient state activities would cause unchecked unemployment that could lead to political turmoil. Surging unemployment, coupled with rising inflation after a rupee devaluation, would be not just politically unpopular but potentially explosive.

The authorities recognized that forgiving or restructuring the debt was a prerequisite for successful reform. With its longstanding arrears, Seychelles had a complicated relationship with creditors. Would they oppose the request for debt relief, given the magnitude of relief required to get the debt to a sustainable footing? At this stage, creditors were relatively unaware of what Seychelles was dealing with. Many creditors, especially those who had invested in international market securities, had never visited the islands, except perhaps a high-end hotel.

As its problems mounted Seychelles had not communicated much with bondholders. Would the country's history of accumulating arrears and inexperience in negotiating with the IMF cause some to doubt its capacity to execute reforms or normalize relations with creditors? Given that creditors were highly fragmented, especially in the case of the Eurobond, how would the state conduct a consensus-driven approach?

The only middle-income countries to benefit from a debt write-off from the Paris Club had major geopolitical influence, such as Iraq and the former Yugoslavia. The Paris Club's Evian Approach was largely untested with severely indebted middle-income countries. How could Seychelles, which had little geopolitical clout, expect to fare? How should the government phase its approach to official bilateral and commercial creditors, since the first group of creditors would effectively set the parameters for others?

The September 2008 bankruptcy of Lehman Brothers—Seychelles' single largest commercial creditor—would complicate restructuring of the commercial debt. How would negotiations be conducted with administrators motivated by different factors than other creditors? The presence of insurers behind a number of other facilities created a similarly complex dynamic.

Coming to One Mind

The biggest fear—one that was well-founded—was that as part of the reform the government would request that some debts be written off or rescheduled. It was fortunate that in the final analysis all parties agreed that debts contracted in local currency would be spared such haircuts, but all debts contracted in hard currency would be subject to an equitable and transparent process of rescheduling. Rescheduling would clearly be painful. Some local banks floated the idea that a free market would substantially erode the country's reserves through capital flight.

The government thus had to hold very firmly to the line that at that point debt rescheduling was necessary for national economic stability. Banks were encouraged to view the problem from a long-term perspective and do their fair share in the difficult reconstruction period. The stage was thus set to end the long economic impasse and usher in a new era.

The Minister of Finance, with the support of the President and the Cabinet of Ministers, played a pivotal role throughout the process by managing the growing momentum associated with planning for change. This is what had to be done:

- The state needed to speedily reverse a situation of primary deficits to one of moderate primary surpluses to pay debts, though in any case they needed to be rescheduled and reduced to amounts compatible with a realistic projection of what the country was able to pay.
- The authorities would need to remove all foreign exchange restrictions and float the rupee.
- The authorities also would need to introduce a new monetary policy, using market-driven instruments to achieve the desired liquidity management.

Time was running out. Decisions needed to be made fast. Every passing day brought new arrears and new unsolved problems. The highest decision-making body had to step in. Technical experts from the Ministry of Finance and the Central Bank were asked to prepare a set of options for the government to consider, and the technicians were told, "All options may be considered and presented."

After the Ministry of Finance talked with the IMF and the World Bank on possible collaboration on a major reform program and was assured of support, the authorities formally invited the IMF to Seychelles to field a mission to examine possible scenarios. Soon after the World Bank fielded a mission soon after to assess the situation and discuss possible support. Discussions at that time covered such areas as assistance to the tuna industry and benchmarking its performance against other tuna-exporting countries.

The IMF mission, led by Paul Mathieu, held discussions with President James Michel and his team, senior cabinet ministers, and the Governor of the Central Bank. The issues facing Seychelles were not new to the IMF, which had fielded countless missions to Seychelles over the previous two decades. This time, it would appear, the IMF's objective was to ascertain the political will for reform and assess the abilities of the technical teams that would be responsible for implementing the ground-breaking decisions ahead.

In August 2008 12 experts from the IMF arrived in Seychelles to work with local technicians on a comprehensive master plan for reform. They included specialists in fiscal matters, monetary and exchange systems, debt restructuring and management, and banking stability. At this point, it was clear to the Ministry of Finance and the Central Bank that devaluation was imminent and serious fiscal reforms would need to kick in.

The Finance Minister coordinated with his technical and managerial staff to carefully design a new fiscal plan that would reflect the changes required: more revenue and less spending. Further work would be needed to plan structural reforms, including privatization, and enhance the governance of state-owned enterprises. Since another central objective was debt reduction, a team was prepared to begin active discussions with creditors and pave the way for debt reduction negotiations, starting with the Paris Club.

These plans needed to be backed by realistic assumptions, dates that would trigger events, and indicators to measure performance. The ministry was also required to ensure that all of these actions were in sync with the monetary reforms to be managed by the Central Bank. A major policy move was to repeal the Foreign Earnings (Regulation) Act, which had imposed the exchange controls. Next would come a float of the rupee and the advent of a new monetary policy, which would use a number of indirect instruments to manage liquidity.

The support of international institutions, especially the multilateral ones, was crucial in catalyzing belief in the coming reforms at the highest level in Seychelles. Senior staff of those institutions spoke to the country's political leaders, encouraging them to forge ahead despite perceived risks and focus on the long-term benefits of revising economic policy. Support from the multilaterals came not only through technical assistance but through direct balance of payments financing: In November 2008, the IMF approved a Stand-By Arrangement (SBA) of SDR 17.6 million, equivalent at the time to US\$28 million, front-loaded with a 70 percent disbursement.¹⁵

¹⁵ Within a year of the reforms being implemented the World Bank and the African Development Bank pledged US\$15 million in total. Other countries also pledged support: Abu Dhabi US\$15 million, China US\$1.5 million, and South Africa US\$3.4 million. Seychelles used a large proportion of these grants to clear domestic arrears.

This support had another significant advantage: it gave the Seychelles reform program considerable credibility. Seychelles was suffering from one of the lowest possible credit ratings, Select Default, for having failed to make a Eurobond payment due in mid-2008. This was the time to address one of Seychelles' major burdens—the large overhanging debt burden.

The Ministry of Finance pressed ahead with meeting creditors while the multilateral organizations were on hand to guide the reform. The effort made by Seychelles and the case in its favor were thus seen to be consistent, realistic, and genuine in the eyes of the international community.

The momentum grew with each passing day. The business community indicated its full support for change, once it knew the IMF would back the country. President Michel began sensitizing world leaders, especially those from supportive countries, to the fact that Seychelles would be embarking on major reform. The intention was to seek their political and financial backing where possible.

Serious reform was inevitable. It spelled the end to indecisiveness and inertia in economic initiatives.

Preparing Stakeholders, the Business Community and the Public

Within the ruling party, there were several schools of thought; some, for instance, thought that a socialist course had never been fully charted. Questions surfaced: Was the population ready to embrace change? Would a devaluation unleash inflation? Where would devaluation end, and ultimately how much would a dollar cost? Would the international community recognize this sacrifice and assist, for example, in bridging financing gaps? What if the measures created more problems and put political stability at risk? What were the backup options? Would the population have any faith in the government thereafter?

It was time for technical experts to come to the fore to answer these probing questions. They did so in televised debates and face-to-face meetings with political influencers to bring about a better understanding of the economic stakes. It was crucial that the authorities had convincing answers to the larger questions that most perturbed everyone.

The Ministry of Finance prepared presentations that clearly explained what was being considered. The most senior technical experts participated in question-and-answer sessions at the senior party, parliamentary, and government levels. In some cases, small group discussions were held, because some participants

would pose questions only privately or with a small audience. As the days passed, momentum built in favor of the reforms, not only in the ruling party but even among the opposition.

Externally, Seychelles encountered little if any opposition. Foreign allies were encouraged to hear of Seychelles' new momentum for change, which in fact many of them had advocated. But creditor nations and some financial institutions clearly saw red flags. A real reform would have to ensure more equity among creditors and more transparency about what Seychelles owed.

Local financial institutions had their own concerns. The history of government budget deficits had caused banks to lend a large part of their deposit base to the state, with the usual guarantees and securities, thus making the state their preferred borrower. This situation was about to change. Banks increasingly would need to lend to the private sector, which would assume the commercial activity previously pursued by the state.

Exchange controls had also benefited the banks by limiting the number of traders in hard currency and encouraging uncompetitive practices. For example, the banks used their leverage in legally handling hard currency to impose banking charges that would have been uncompetitive if there were no controls. A potential advantage of reforms for bankers, however, was the prospect of financial gain as the value of the Seychelles rupee fell.

On the political front, the ruling party quietly crafted a large-scale mobilization plan. The minister of finance kept other cabinet ministers and parliamentarians updated on the policies being considered and how they would need to be defended politically. High-profile TV programs invited as guests senior Ministry of Finance officials, bank managers, private businessmen, and academics to discuss the economic issues and the need for reform. Care was taken to use terms and messages consistently to ensure broad support.

The state newspaper carried special features on economic issues, the possible need for a radical departure, and unprecedented levels of debate from different points of view. District politicians mounted door-to-door campaigns to raise public awareness about the need for change given the evolving global recession.

The private sector, through the Chamber of Commerce, actively backed a program of real reforms, and politicians were all asked to lend the country their support as it went through the difficult reform period soon to come. The minister of finance met with private sector leaders, especially in tourism, to tell them about the serious changes being contemplated and seek their views.

Within government, the minister of finance and his principal secretary briefed all chief executive officers and principal secretaries, along with their head planners,

about the need to think differently and to plan for a period of rejuvenation. They were asked many probing questions that often required detailed answers. The meetings emphasized the following messages:

- The economy would be driven by market forces.
- Government would now have a much smaller role in industry and would concentrate on regulation.
- Universal subsidies would be eliminated; every entity would have to fend for itself.
- The state would protect the poor and vulnerable through a means-tested welfare agency, funded from savings generated by more efficient government operations and cuts in subsidies.

Another point emphasized was that reforms were being enacted because they would eliminate shortages of hard currency, severely curtail bureaucracy, and foster a new business environment that could generate growth. The winds of change could clearly be felt. It was evident—perhaps because no major protests arose—that broad-based support was coalescing around a realistic and serious reform plan.

Moving into Action: A Top-Down Approach to Building a Fiscal Surplus

If reforms were to succeed, stakeholders needed to believe in them. The measures needed to be presented forcefully, because they were so extensive that their effects would be felt nationwide. The reforms needed both technical and political champions.

At the technical level the Ministry of Finance took the lead. The sequence of each task related to the reforms, and who would be responsible for them, were naturally central questions. The first task was to create a large primary surplus. That effort would dovetail with even more challenging tasks: curbing liquidity while freeing the exchange system.

Naturally there were drawbacks and difficulties. The members of the Ministry of Finance and Central Bank teams were young, dynamic professionals, but they had never had to manage change on such a scale, let alone worked within a macroeconomic framework that factored in the complexities of a small economy. Their job required thinking that was a radical departure from the past. It was not entirely unexpected when some key personnel were changed a few months into the planning period.

Restructuring at the Central Bank

A month before the reform program was launched, Francis Chang-Leng, the governor of the Central Bank, resigned. Pierre Laporte replaced him. Mr. Laporte, a Seychellois working for the IMF, was no stranger to the issues. When he had left Seychelles only six years previously, the economic problems were already fairly acute. Having worked for the IMF, he completely understood the urgency of reform and could interact on technical issues with the IMF and other development partners. Mr. Laporte was not only respected within technical circles but also got on extremely well with his counterparts, which reinforced the team championing the reforms.

Not Much Turnover Elsewhere

The reform program had received popular acclaim within as well as beyond the public service. The solutions, belated though they were, were well communicated and had broad political support. Except for the governorship of the Central Bank, the government saw no reason to shuffle any senior positions. The decision-makers in all ministries and public enterprises were prepared to do their job to ensure the reforms rolled out with vigor at the necessary speed.

Continuous Interaction with the People

The pace was unrelenting. The authorities rolled out successive waves of actions. Although at first inflation rose, the reforms were generally well accepted by the people, largely because of how carefully they were undertaken. For example, when the government needed to entice almost 17 percent of the public service workforce to resign or retire voluntarily, teams were set up to explain the measure and its purpose to both public servants and the population at large. An important message was that the goal was to redeploy those leaving public service—the idea was not to create unemployment but to reduce the size of the public workforce. The government set up teams to help those leaving to find new jobs in the private sector. Publicizing this measure reinforced the sense that everyone was together in the reform effort.¹⁶ People united

¹⁶ However, it should also be noted that the labor reforms were painful for some employees. Some employment risks were shifted to them when they joined the private sector, and some claimed that their salaries were lower.

and gained a sense of ownership of what was happening. Nobody would be left on their own.

In difficult times, what can be very detrimental to smooth and gradual change are sudden negative surprises. In Seychelles, there were price increases but almost all came about only after everyone had plenty of warning. As increases were announced, the media, particularly the state media, explained their rationale and where necessary provided details on how increases were calculated. Notably, the increases were timed to follow not only receipts as budgeted but also systematic increases in either wages or the budget of the welfare agency.

The authorities stayed close to the people through district consultations. The president personally led town hall meetings to discuss developments, especially the economic reforms. Ministers usually flanked the president, and where specific issues had been identified in advance, knowledgeable technicians or executives were also in attendance. People were encouraged to speak freely in the presence of national media.

It was a time to share experiences, gather new information, understand expectations, and really feel the pulse of the population. Such feedback gave the authorities a good sense of how the reforms were being perceived and how to tackle weaknesses promptly. The Seychellois were able to be reassured from the highest level that reforms were not being done at the people's expense. These considerations, which minimized resistance in both the institutional and public arenas, were critical to maintaining the pace of the reforms.

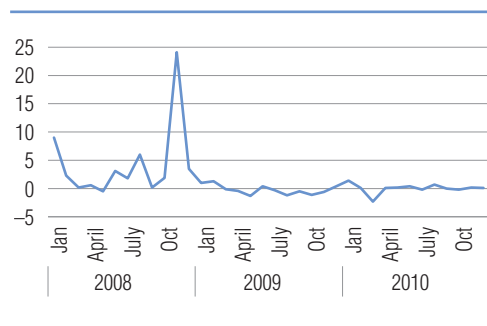
3

The Reform Program and Its Results

Seychelles has come a long way since 2008. With the support of the IMF, the World Bank, and other partners, the government embarked on structural reforms to address fiscal, debt, and external imbalances. Economic restructuring began with a fundamental liberalization of the exchange rate regime, significant and sustained tightening of fiscal policy, reform of monetary policy to focus on liquidity management, and a boost to private development by reducing the state's role in the economy. The spending adjustment centered on slimming government employment. The IMF approved an 18-month standby arrangement in the amount of SDR 17.6 million, equivalent to 200 percent of the Seychelles quota in the Fund. Budget support followed from the World Bank and African Development Bank for an amount exceeding US\$30 million.

Although a float of the currency on November 1, 2008 caused a nominal depreciation of more than 50 percent, monthly inflation was reduced from close to 25 percent that month to virtually zero by February 2009—in just four months (Figure 3.1).¹⁷ The 2009 budget removed universal subsidies and tax loopholes, effecting a tightening of 11 percent of GDP. On the finance side, all exchange restrictions were lifted, interest rates were freed, and a simple reserve money policy was quickly put in place. The public debt portfolio with the Paris Club

Figure 3.1 Consumer Price Inflation, 2008–10 (Month on Month)



Source: National Bureau of Statistics, Seychelles.

¹⁷ In November annual inflation exceeded 60 percent, following the huge monthly 25 percent price shock.

and other private creditors was restructured. Seychelles received generous debt relief, which together with fiscal consolidation has vastly improved its fiscal and debt profile. The generous system of income support for low-income households and individuals without income was maintained throughout.

The Exchange Rate, Exchange Regime Reform, and Monetary Policy

The decision to approach creditors for restructuring external debt was followed, on November 1, 2008, by the float of the exchange rate and elimination of exchange controls.¹⁸ These bold steps were designed to purposefully move the economy away from administrative controls and let market forces freely determine the exchange rate. This meant all economic agents had to have free access to foreign exchange. Credit conditions were tightened, at least initially, to promote capital reflows and contain demand-side inflationary pressures.

When the exchange rate was liberalized, many local prices already reflected the parallel exchange rate. For this reason, price increases were expected to be modest. Other policy changes, such as liberalization of imports and elimination of import licensing requirements, were expected to contribute to modest price increases by improving domestic supply. Yet consumer prices, which had already risen by 32 percent in the first 10 months of 2008 as commodity prices shot up in the international market, jumped by another 24 percent in November after the exchange rate float. By the end of the year, prices were up 63 percent for the year. Fortunately, the move to the floating rate coincided with steep drop in international prices for petroleum and petroleum product prices, which limited the local price increase.

To stimulate capital inflows and support the exchange rate, in the last quarter of 2008 monetary policy was tightened. The Central Bank discount rate increased sharply, and indirect market-based instruments were adopted to regulate monetary conditions. For instance, in September 2008 weekly auctions for a liquidity deposit facility at the Central Bank were introduced; banks could deposit funds for 7, 14, and 28 days, and weekly T-bill auctions were open to both banks and the non-bank public.

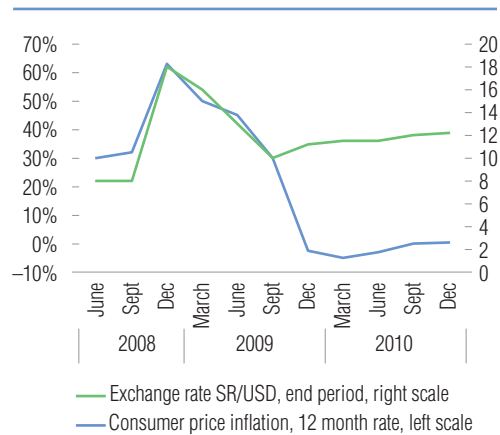
In December 2008 foreign exchange bureaus were licensed to facilitate the buying and selling of foreign exchange for small operators and tourists. To deepen interbank transactions, Central Bank interventions in the foreign exchange market

¹⁸ The IMF also provided extensive technical assistance in support of the revised exchange law, formulation of the new monetary policy, and more forceful banking supervision and debt management.

were strictly limited to preventing exceptional volatility and ensuring orderly market conditions. In early 2009, Central Bank instruments were widened by standing credit facilities and repurchase (repo) and reverse repurchase transactions, using the Central Bank's T-bill portfolio. Significant sales of T-bills to the non-bank public helped to sterilize liquidity and support the rupee. In the course of 2009 the liquidity asset ratio was gradually phased out.

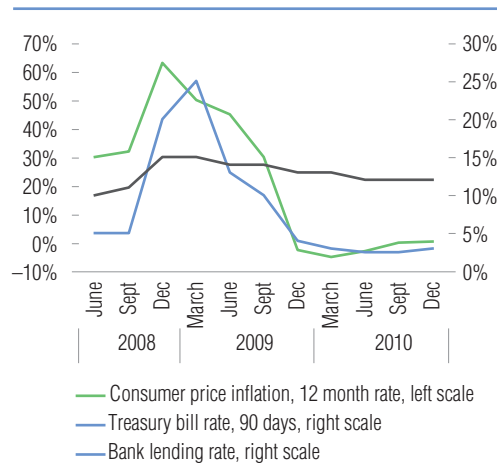
The initial steep depreciation brought the exchange rate well below what had prevailed in the parallel market right before the float decision. By mid-2009 the exchange rate appreciated to SR 14 per US\$1 by mid-2009 and by year-end to SR11.1 per US\$1 (figure 3.2), as the liquidity sterilization operations took effect; the successful sale of T-bills led banks to sell their foreign exchange holdings and also induced residents to repatriate capital from abroad. The initial spike in weekly auction T-bill rates, which peaked at 29 percent in January 2009, was reversed within six months as confidence in the rupee returned. By mid-2009, the T-bill rate had fallen below 15 percent and it continued the slide, to less than 10 percent, in the second half of 2009 (figure 3.3). In the first quarter of 2009 price inflation abated substantially, after international food prices declined and the rupee appreciated at the end of 2008. During 2009 consumer prices fell by 2.5 percent. In 2010 the exchange rate was fairly stable, moving from SR 11.1 per US\$1 to SR 12.2 per US\$1, which helped keep consumer price inflation close to zero.

Figure 3.2 Consumer Price Inflation and the Exchange Rate, 2008–11



Source: Ministry of Finance.

Figure 3.3 Consumer Price Inflation, T-bill Rate, and Bank Lending Rate, 2008–11



Source: Ministry of Finance.

Solid budgetary performance in both 2009 and 2010, with a primary surplus that exceeded IMF program targets, allowed the government to retire much of its domestic debt, leaving the banks with excess reserves that amounted to about 4 percent of GDP at the end of 2010. Because this caused some concern, it was decided early in 2011 to mop up reserves through a slight increase in the reserve requirement. Bank credit to the private sector, which had declined despite sustained inflation in 2009, rebounded in 2010, but at 25 percent of GDP it was still low in relation to comparable countries. The bank lending rate was raised to about 15 percent at the end of 2008 and then gradually declined, with periodic adjustments, to 12 percent at the end of 2010 and closer to 11 percent through 2011 (figure 14). Chapter 5 examines how credit for small and medium enterprises and mortgage lending to households were expanded.

2009–12: Budgetary Reforms and Fiscal Performance

The government recognized that the exchange reforms of 2008 had to be accompanied by comprehensive modernization of public finances, in both tax and budgetary procedures, to mobilize resources more fairly, improve spending efficiency, and tighten controls. The intent was to attain the budgetary surpluses needed to reduce the public debt.

The goal of the 2009 budget was a large primary surplus of 6.2 percent of GDP in order to limit the pressure of aggregate demand on domestic prices and the exchange rate and allow for reduction of domestic debt. The surplus was to be amassed by limiting government capital investments while protecting allocations to priority sectors, such as health, education, and welfare transfers. The wage bill was programmed to decline significantly as a share of GDP, from 7.9 percent in 2008 to 7.1 percent in 2009.

In the event, the macroeconomic aggregates were better than expected. The primary budget surplus, equivalent to 14.3 percent of GDP, was more than double what was targeted, partly because in 2008 the Seychelles Petroleum Company repaid a large loan from the government (representing 3 percent of GDP), but also because revenue exceeded forecasts by a wide margin (1.2 percent of originally projected GDP), and external grants were higher by 4.1 percent of GDT than programmed (table 3.1).

Current expenditure was kept below programmed levels (by 2.3 percent of originally projected GDP) because of lower interest outlays; other expenditure components were as expected. The wage bill rose by only 11 percent, despite the

Table 3.1 Government Finances in 2009, 2010, and 2011: Actual versus Programmed

| | 2009 | | | | 2010 | | | | 2011 | | | |
|-------------------------------------|-------------|-------------|-----------------------------|-------------|-------------|-------------|--------------------------|-------------|-------------|-------------|--------------------------|-------------|
| | program | | difference (actual vs prog) | | program | | difference (act v. prog) | | program | | difference (act v. prog) | |
| | SR millions | SR % of GDP | SR millions | SR % of GDP | SR millions | SR % of GDP | SR millions | SR % of GDP | SR millions | SR % of GDP | SR millions | SR % of GDP |
| Tax revenue | 3544 | 2.2% | 3793 | 2.2% | 3090 | 3.8% | 3527 | 3.8% | 3905 | 4.5% | 4156 | 2.0% |
| <i>Of which</i> GST | 1442 | -0.8% | 1348 | -0.8% | 1282 | -1.8% | 1078 | -1.8% | 1216 | -1.8% | 1215 | -1.0% |
| Business taxes | 551 | 2.2% | 802 | 2.2% | 602 | 1.7% | 796 | 1.7% | 772 | 1.7% | 872 | 0.8% |
| Trade and excise taxes | 352 | 0.7% | 437 | 0.7% | 491 | 0.7% | 369 | -1.0% | 941 | 1.6% | 1143 | 1.6% |
| External grants | 5 | 3.2% | 373 | 3.2% | 352 | -1.6% | 170 | -1.6% | 475 | -0.1% | 459 | -0.1% |
| Expenditure and net lending | 4303 | -5.9% | 3625 | -5.9% | 3788 | 0.8% | 3878 | 0.8% | 4667 | 2.2% | 4941 | 2.2% |
| Current expenditure | 3647 | -2.8% | 3329 | -2.8% | 3244 | 0.6% | 3315 | 0.6% | 3455 | 2.1% | 3712 | 2.1% |
| <i>Of which:</i> wages and salaries | 747 | 0.2% | 766 | 0.2% | 735 | -0.4% | 694 | -0.4% | 906 | 0.2% | 935 | 0.2% |
| goods and services | 625 | 0.8% | 715 | 0.8% | 777 | 1.3% | 925 | 1.3% | 973 | 0.4% | 1022 | 0.4% |
| Transfers | 905 | -1.1% | 783 | -1.1% | 341 | -1.0% | 224 | -1.0% | 1241 | 1.0% | 1362 | 1.0% |
| Interest payments | 1361 | -2.8% | 1046 | -2.8% | 755 | 0.0% | 759 | 0.0% | 322 | 0.4% | 374 | 0.4% |
| Capital expenditure and contingency | 656 | -0.4% | 608 | -0.4% | 833 | 1.0% | 948 | 1.0% | 1211 | 0.0% | 1216 | 0.0% |
| Net lending | 0 | -2.8% | -315 | -2.8% | -349 | -0.3% | -385 | -0.3% | 2 | 0.1% | 13 | 0.1% |
| Primary balance | 622 | 8.4% | 1586 | 8.4% | 833 | 1.9% | 1059 | 1.9% | 536 | 0.2% | 566 | 0.2% |
| In % of GDP | 6.2% | 8.6% | 14.8% | 8.6% | 7.4% | 2.0% | 9.4% | 2.0% | 4.5% | 4.5% | 4.5% | 0.2% |
| Nominal GDP | 9970 | | 11450 | | 11206 | | 11621 | | 12016 | | 12470 | |
| Real GDP growth, in % | -0.50% | | 0.50% | | 4.00% | | 6.70% | | 4.00% | | 5.00% | |
| GDP deflator, % change | 27.20% | | 25.20% | | 1.10% | | -4.90% | | 2.30% | | 2.20% | |

Source: Ministry of Finance.

adjustment given to offset the consumer price increase, because the number of civil servants staff had declined by 15 percent (see chapter 2). The government protected allocations to social programs, which rose by almost 50 percent, to reflect needs related to the dismissal of personnel, but transfers to autonomous public entities were reduced because they had fewer personnel. Capital expenditures, which had been cut by almost 50 percent in 2008, were almost tripled to allow for necessary outlays for housing, roads, and maintenance. In particular, capital grants to the Public Utility Corporation (PUC) were increased. The large surplus achieved (SR 600 million, 5.2 percent of GDP), in addition to net external financing, allowed the government to redeem almost SR 800 million of T-bills from domestic holders; partly as a result, domestic debt plunged, from 47 percent of GDP in 2008 to 31 percent in 2009. To ensure sound debt management and ensure that public agencies could not contract debt without the consent of the central government, a Public Debt Management Act was adopted early in 2009.

Tax reforms were not neglected:

- A personal income tax (PIT) was introduced in mid-2010 to replace the social security tax.
- Goods and services tax (GST) rates were harmonized and cascading effects eliminated.
- The business tax was streamlined to reduce differences between sectors and types of taxpayers.
- The scope of excise taxes was broadened and exemptions limited.
- The VAT replaced the GST.

These reforms started in 2010 and proceeded through 2011 and 2012 until the VAT was introduced on January 1, 2013. Reforms also included centralizing cash balances by adopting setting up a Treasury Single Account, bringing budget-dependent agencies into the central government budget, and reinforcing budget execution.

The objectives of comprehensive tax reforms were to eliminate distortions and differential treatment of sectors, limit exemptions, and avoid cascading effects. Many of the exemptions had been given to attract new investment and compensate for the overvalued exchange rate. The GST, introduced in 2003, was a very important revenue producer, accounting between 2004 and 2008 for 40–50 percent of revenue. However, the GST was designed very differently from broad-based consumption taxes like those in Canada, Australia, and New Zealand. Instead, it combined a turnover tax on selected goods and services with an excise tax on imports and on locally manufactured alcohol, petroleum products, and tobacco. Many goods, services, and activities were exempt.

In 2008 the Ministry of Finance prepared a detailed list of GST exemptions: They were granted for goods and services provided by utilities, for public transport, and for construction. They were also granted for some imported goods, depending on why they were imported—for instance, goods used in production of certain other goods, such as tap water and electricity, were exempt, as were imports for capital equipment and the construction materials used by certain economic agents, such as licensed telecommunication providers, medical service providers, educational institutions, and transport operators. They were also granted for certain finished products, such as solar panels, a variety of foodstuffs, and energy-saving light bulbs. Finally, there were the exemptions and concessions granted under the Agriculture and Fishery Act of 2005, the Tourism (Incentives) Act of 2003, and the Fisheries (Incentives) Act of 2005.

While the normal rate of GST was 15 percent, the GST on tourism services had been set originally at 7 percent and was raised to 10 percent in January 2009. GSTs on alcohol, tobacco, and petroleum products were also fixed.

The intent of reforming the GST system was to reduce wide-ranging exemptions and harmonize the rate at 15 percent. The GST on the tourism sector was raised to 12 percent on November 1, 2010, and to 15 percent on November 1, 2011. After January 2010, the GST was extended to all consultancy and corporate service providers. To avoid cascading effects, starting on January 1, 2010, all products used as inputs in sectors whose goods and services were subject to the GST at the consumption level were exempt from GST at the import level. The retail markup to calculate GST was also eliminated effective January 1, 2010. To simplify the system, the specific rate on petroleum, alcohol, and tobacco products was eliminated at the same time, and these products were covered by specific excises. At the same time, the specific trade tax on these products was reduced; this change reduced the scope of tax exemption, for instance, on the petroleum consumed by tour operators, hotels not connected to the electricity grid, and fishermen, because the exemptions applied only to trade tax, not excises (Table 3.2). Also, PUC, previously fully tax exempt, was subject to the excise on heavy fuel.

Table 3.2 Revision of Taxes on Petroleum Products (SR per liter), 2010

| Product | 2009 | | 2010 | |
|-----------------------|------|------------|------|------------|
| | GST | Trades Tax | GST | Trades Tax |
| Avgas | 2.0 | 0 | 2.0 | 0 |
| Motor spirit | 2.0 | 6 | 4.0 | 4 |
| Kerosene | 2.0 | 6 | 4.0 | 4 |
| Illuminating kerosene | 2.0 | 6 | 4.0 | 4 |
| Gas oil | 2.0 | 6 | 4.0 | 4 |
| LPG | 0.5 | 0 | 0.5 | 0 |
| Heavy fuel oil | 1.0 | 3 | 0.5 | 3 |

Source: Ministry of Finance.

The business tax was reformed to lower the tax rate while reducing the threshold under which businesses were tax-exempt, which at SR 250,000 was considered too high. The tax rate for companies was brought down from 40 percent to 33 percent effective January 1, 2010. A lower rate of 25 percent was introduced for companies with turnover of less than SR 1 million; the threshold for tax exemption was eliminated for companies but maintained at a lower level for sole proprietors and trusts. These were subject to the PIT rate for turnover of less than SR 1 million (table 3.3). Tax concessions under the Investment Promotion Act of 1994, the Tourism (Incentives) Act of 2003, amended in 2008, and the Agriculture and Fisheries (Incentives) Act of 2005, which provide for a profit tax rate of 15 percent, were not modified because it was felt that changes could not be applied retroactively to businesses that had received concession certificates. Those certificates also provide for generous accelerated tax depreciation allowances of up to 150 percent of development costs on hotel buildings, plant, and machinery.

In 2010 budgetary policy was again directed at achieving a significant primary surplus to further reduce debt. The good performance of revenue made it possible to preserve priority sectors from excessive cuts and protect capital spending for housing, roads, and grants to the PUC. Revenue again exceeded projections (equivalent to 34.5 percent of GDP, compared with the projected 31.4 percent). Business tax receipts exceeded expectations by almost 2 percent of GDP because in the first few months of 2009 telecom companies earned high profits and banks profited from high T-bill rates and the low exchange rate for the rupee.

Table 3.3 Revision of the Business Tax, 2009–13

| Revisions | 2009 | 2010 | 2011–12 | 2013 |
|--|---------|---------|---------|--|
| Sole traders and partnerships | | | | |
| Threshold on turnover (SR) | 250,000 | 150,000 | 150,000 | 150,001 |
| Below threshold (tax rate, %) | 0 | 0 | 0 | 0 |
| Between threshold and SR 1 million (tax rate, %) | 40 | 18.7514 | 15 | 15 |
| Above SR 1 million (tax rate, %) | 40 | 33 | 33 | 30 |
| Companies and trusts | | | | |
| Threshold on turnover (SR) | 250,000 | 0 | 0 | 0 |
| Between threshold and SR 1 million (tax rate, %) | 40 | 25 | 25 | Replaced by a 2.5% tax based on turnover |
| Above SR 1 million (tax rate, %) | 40 | 33 | 33 | 30 |

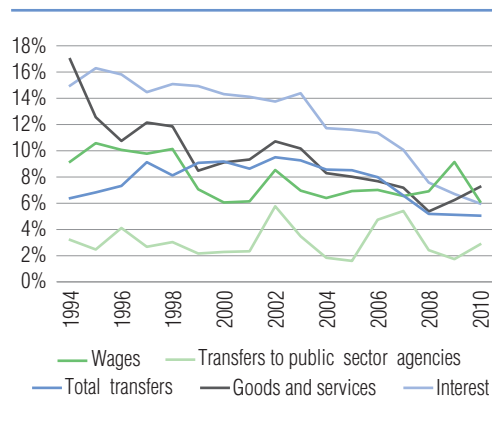
Source: Ministry of Finance.

Introduction of the PIT to replace the social security tax, effective July 1, 2010,¹⁹ was a major step in modernizing the tax system and eliminating differential treatment of categories of taxpayers. Until September 30, 2010, the PIT was 18.5 percent, the effective rate of the social security tax levied on employees; effective October 1, the PIT rate was lowered to 15 percent. The old social security tax was levied at 10 percent on tourism workers and was not levied at all on expatriate workers; for these two categories, the PIT was again at 15 percent so that by 2011 the PIT rate would be unified across all categories.

Preparations for the VAT started early. The bill was introduced in the National Assembly in December 2010, with a view to having the tax go into effect in July 2012. This reform required extensive consultation with the business community, retailers associations, and civil society organizations to ensure wide dissemination of the concepts underlying it. The government adopted the regulations, including rates, thresholds, and exemptions, in the second half of 2011. With externally funded technical assistance, a detailed operational manual was prepared. Ultimately, to better prepare taxpayers, the VAT did not enter into effect until January 1, 2013.

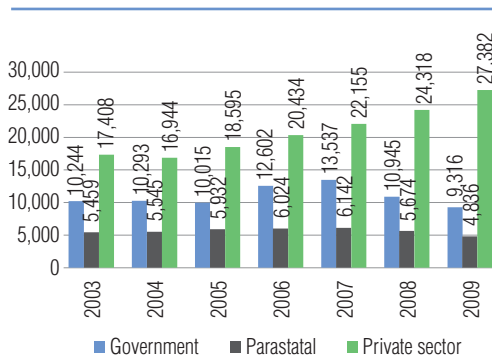
The public service was downsized in 2010 (figures 3.4–3.7). The downsizing was achieved with a successful manpower budgeting exercise conducted in the first quarter of 2008, an early

Figure 3.4 Current Expenditure, 1994–2010
(Percent of GDP)



Source: Ministry of Finance.

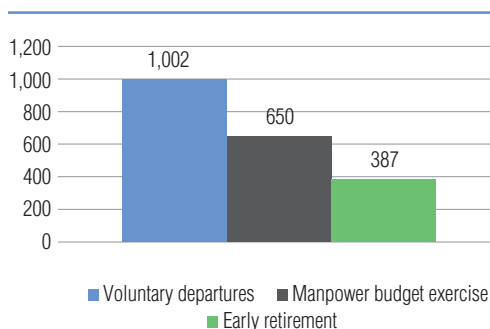
Figure 3.5 Employees by Sector (Thousands)



Source: Ministry of Finance.

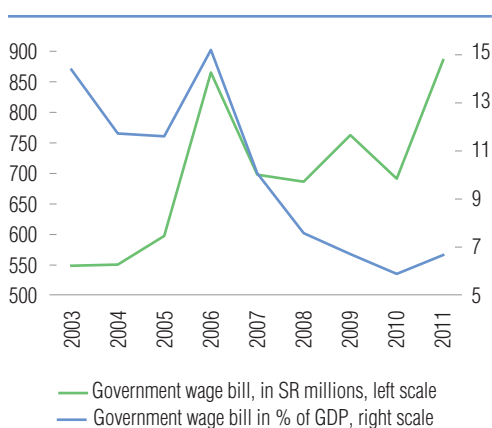
¹⁹ The social security tax, levied up to 2009 at 20 percent on all wages (paid by the employer), with a lower rate of 10 percent on tourism employees, supplemented by a 2.5 percent levy on employees, has always yielded sufficient revenue to cover outlays. In fact by year-end 2009 the system had accumulated a surplus of about SR 300 million (3 percent of GDP). At that point the social security system was replaced by a PIT, and benefits began to be paid out of general government revenue.

Figure 3.6 Government Personnel Reductions, 2008–09
(Percent of Population)



Source: Ministry of Finance.

Figure 3.7 Government Wage Bill, 2003–11
(SR millions; Percent of GDP)



Source: Ministry of Finance.

retirement scheme, and a voluntary departure program. These three schemes saved 10 percent of the wage bill (3 percent of primary spending). Of the total wage bill savings, 3 percent was due to the manpower budgeting scheme and 7 percent to early retirement (390 employees) and voluntary departure (1,002 employees; figure 3.4). These departures made it possible to introduce a wage adjustment to offset the inflation in 2008 without increasing the total wage bill. The wage bill fell significantly as a share of rapidly increasing nominal GDP, from 10.6 percent of GDP in 2007 to 6.7 percent in 2009, and in 2010 it fell further, to 6 percent (figure 3.5).

The notable element of this reform is that it was carried out without damage to key services. Yet as a share of the total population, government employment fell from 15 percent in 2006 to 11 percent in 2009.

In 2011 the primary surplus reached 5.6 percent of GDP, comfortably above the target (4.5 percent of GDP), and revenue exceeded the target by a wide margin (6 percent of GDP). The additional resources were used to temporarily stabilize energy prices and support the

national airline. Air Seychelles had incurred large operational losses, equivalent in 2011 to 2.5 percent of GDP, of which the government covered two-thirds. Transfers to social programs were kept below target. Measures to curtail the airline's losses, mainly by cutting routes and reducing the fleet, were identified in October 2011 and put into effect in early 2012. All in all, macroeconomic outcomes in 2011 exceeded the government's targets.

The Budget Law for 2013 brought further changes to widen the tax net and deter evasion. The profit tax for enterprises with turnover of less than SR 1 million was replaced by a flat tax of 2.5 percent on turnover. The law cut the corporate tax rate

from 33 percent to 30 percent (except for banks, insurance companies, telecom companies, and tobacco manufacturers). It also introduced a corporate responsibility tax of 0.5 percent of turnover for all businesses with turnover exceeding SR1 million; the proceeds will be channeled to small-scale community infrastructure projects. Finally, the 2013 budget law levies a tourism marketing tax of 0.5 percent of turnover on tourism-related establishments and bank and telecom companies, with proceeds channeled to broaden the activities of the Seychelles Tourism Marketing Board.

Reforms of the Social Security Fund and the Pension Fund

The National Assembly approved a new Social Security Act in July 2010 that merged the Social Security Fund Administration into the Seychelles Welfare Agency to avoid duplication of services and improve administrative efficiency. The Welfare Agency was revamped to better target the social safety net to those in need and better link benefits and wages to incentives for training and job search. The reform also gives the Social Security Fund an independent board of trustees to ensure professional and independent management of its assets, which include both financial assets and real estate. The board, appointed in December 2010, was charged with formulating investment objectives for managing those assets by September 20, 2011, based on recommendations from a World Bank report.

The Seychelles Pension Fund, established in 2005 as the successor to the Pension Scheme created in 1991, pays a pension to retiring employees in an amount related to their final salary. This pension is a supplement to the fixed amount paid to every resident citizen by the Social Security Fund. Because of concern that the flat contribution paid by employers and employees (SR 50 a month each from January 1, 2008, up from SR 25 contributed by employees before 2008) was inadequate to cover pension fund needs, in 2010 an international accounting firm prepared an actuarial study. The study recommended moving to contributions as a percentage of salary. The rate was set at 1 percent for 2011 and was increased to 1.5 percent in 2012, with a further increase to be introduced in 2014 to ensure the actuarial equilibrium of the Seychelles Pension Fund.

External Debt Restructuring

Seychelles began to contact creditors in the second half of 2008 in order to restructure external debt, which at 79 percent of GDP (about US\$750 million) was not only

mostly in arrears but was in any case unsustainable.²⁰ Official creditors agreed to consider a restructuring their claims if the IMF SBA program was carried out in a satisfactory manner, as evidenced by successive reviews, and if other creditors, both bilateral official and private, would agree to comparable terms.

The Paris Club creditors met in April 2009 and agreed to grant exceptional treatment to Seychelles using the Evian Approach, in which arrears were normalized, the stock of debt reduced by 45 percent, and the residual amount rescheduled over 18 years with a 5-year grace period. The 45 percent cancellation was scheduled in two tranches. Half of the cancellation, 22.5 percent, became effective in June 2009 after the second review of the SBA and the other half in June 2010, after the first review of a successor IMF arrangement. Debt relief was granted in recognition that Seychelles had limited capacity to repay debt and needed to restore longer-term debt sustainability; it was predicated on other official and private creditors extending comparable treatment. In October 2009 the World Bank finalized an Interim Strategy Note that laid out an approach to restarting a lending program, subject to satisfactory review of the government's stabilization program and the entry into force of the debt restructuring agreements with the Paris Club and commercial creditors. The program consisted of two Development Policy Loans (DPLs) that would carry a maximum exposure of US\$18 million, equally divided between FY10 and FY11. A month later, in November, the Bank approved the first DPL for US\$ 9 million, \$6.4 million of which was disbursed in January 2010.

At the conclusion of extensive negotiations with non-Paris Club official creditors, commercial banks, and external holders of Seychelles securities, the government was able to obtain comparable debt restructuring. Commercial banks that had extended credit to the government converted their claims into credits with a very long maturity and grace period and a low interest rate. The external bonds (the Eurobond issued in 2006 and due in 2011 and a private placement in mid-2007, for a total amount of US\$ 315 million) became part of a debt exchange: they were exchanged for new bonds, with a 50 percent debt cancellation. The remaining debt will be repaid over 16 years with a step-up interest rate structure and 6 years grace on principal repayments. An extensive presentation was made to private debt holders in various financial centers, and participation in the debt exchange was close to 100 percent, so there was no residual holdout creditor problem.

With these debt agreements, external public debt was reduced to an estimated US\$483 million by the end of 2010, about 49 percent of GDP (Table 3.4). External

²⁰ Eighteen percent of the total was in arrears; see Chapter 2, Table 2.

public debt is projected to decline to about 48 percent of GDP by 2015, taking into account some borrowing by the government and the PUC for priority infrastructure, for which new agreements should be limited to a maximum of US\$ 40 million a year entailing annual disbursements of about US\$15–20 million (Figure 18). Even if there are negative shocks to growth and the exchange rate, external debt seems sustainable.

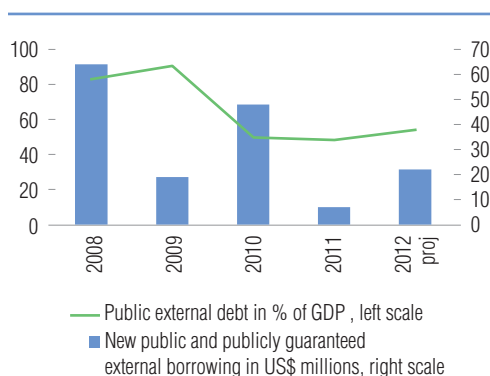
Total public debt, which in 2010 fell to 75 percent of GDP after domestic debt was retired thanks to the primary surpluses in 2009–10 and external debt was re-structured, is expected to continue falling, to about 60 percent of GDP by 2015 and 50 percent by 2018 (figures 3.8 and 3.9). This is to be achieved by primary surpluses in the government budget of about 4–4.5 percent of GDP a year.

Table 3.4 External Debt, 2008–10

| | 2008 | | 2012 | |
|---|---------------|----------|---------------|----------|
| | US\$ millions | % of GDP | US\$ millions | % of GDP |
| Total external debt , including arrears | 750.6 | 79.2% | 470 | 42.2% |
| Multilaterals | 52.2 | 5.5% | 90 | 8.0% |
| African Development Bank | 16.2 | 1.7% | 31 | 2.8% |
| BADEA | | | 15 | 1.3% |
| IBRD | | | 24 | 2.2% |
| OPEC Fund | 12.5 | 1.3% | | |
| Bilateral | 239.5 | 25.0% | 141.5 | 12.7% |
| Paris Club | 137.5 | 14.4% | 81 | 7.3% |
| Others | 102.0 | 10.7% | 81 | 7.3% |
| Commercial | 467.2 | 48.8% | 68.4 | 6.1% |
| Commercial loans | 345.0 | 36.0% | | |
| Bonds and notes | 122.2 | 12.8% | | |
| External debt arrears | 333.5 | 34.8% | 0 | 0.0% |
| Multilaterals | 0.0 | | | |
| Bilateral | 178.8 | | | |
| Paris Club | 121.8 | | | |
| Others | 56.9 | | | |
| Commercial debt | 137.9 | | | |
| Commercial loans | 20.0 | | | |
| Bonds and notes | 85.5 | | | |
| Nominal GDP (US\$ millions) | 957.6 | | 1113 | |

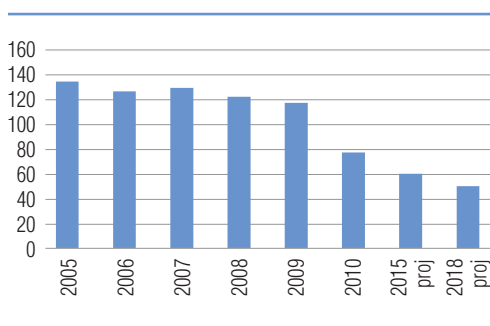
Source: Ministry of Finance.

Figure 3.8 Public External Debt and External Borrowing, 2008–15



Source: Ministry of Finance.

Figure 3.9 Government External and Domestic Debt, 2005–18
(Percent of GDP)



Source: Ministry of Finance.

Strengthening Public Financial Management

To ensure that the adjustment program moves ahead efficiently and improve management of public resources, the Ministry of Finance needed to build up its capabilities for forecasting and budgetary monitoring. It also needed to reinforce controls on public enterprises and budget-dependent autonomous public agencies. A forecasting and analysis branch was established in the ministry to prepare revenue forecasts. As for monitoring public enterprises, the legal basis was parliamentary approval in mid-2010 of the Public Enterprise Monitoring and Control Act, mandating more comprehensive reporting and setting uniform rules for governance, including appointment of a chief executive officer and board of directors and specifying the role of supervisory ministries. The ministry set up a unit tasked with closely monitoring the financial and operational data of public enterprises and conducting periodic audits.

To further tighten controls on public enterprises, the monitoring unit has now been transformed into an independent commission, with a chief executive, which started up early in 2013.

Closer attention was also given to preparation and monitoring of the capital budget, especially requests for capital grants to public enterprises to execute priority infrastructure projects. Beginning in 2013, the capital budget is presented in a Public Sector Investment Program (PSIP) framework which lays out the five-year investment program. In the 2011 budget, all tax resources from budget-dependent agencies were included in government revenue and expenditures in central government outlays.

The main results were better budget preparation, with careful analysis of sectoral growth prospects that could affect revenue, and closer monitoring of public

enterprises. In particular, the capital needs of PUC and Seychelles Transport Company were kept under review, and these companies remained in close contact with the Ministry of Finance regarding their financial results. The PUC's need for successive tariff adjustments as fuel costs rose was especially closely monitored, with a series of adjustments in 2011–12. The tariff adjustments were mainly limited to government and business, with tariff increases for households limited because of social concerns. To place the tariff on a sound economic footing (one that would cover PUC's capital costs), a comprehensive study was carried out in 2012 with the support of the World Bank.²¹

Despite the closer monitoring of public enterprises, the financial difficulties of Air Seychelles, which came to the fore at the end of 2010 and required large loans guaranteed by the government, were unexpected because of opacity rather than transparency in management.²²

²¹ Implementation of the recommendations will be gradual, as the study calls for a substantial increase in the tariff for households.

²² In January 2012, a solution to the airline's weakness was found in a long-term strategic partnership with Abu Dhabi-based Etihad Airways. The agreement included a capital injection from Etihad of US\$20 million in exchange for a 40 percent stake in the company and provision of a US\$25 million shareholder loan on a as-needed basis. For its part, the Seychelles government assumed liabilities to domestic banks and suppliers equivalent to US\$ 21 million, assumed the cost of downsizing and lease termination (US\$ 8 million), and agreed to inject US\$20 million of capital in two equal tranches in 2012 and 2013. Because the airline performed well in 2012, these capital contributions have been deferred. The debt assumed is equivalent to 2.3 percent of GDP and raises the public debt to GDP ratio for the end of 2012 modestly, to 82 percent.

4

Medium-term Challenges: A Sound Budget and Structural Reforms

With the first phase of adjustment well underway, Seychelles must now stay on the economic path to long-term stability and growth, renewed infrastructure, and higher productivity. At the same time, it must continue its commitment to making public debt sustainable.²³

While major reforms have been completed, the reform agenda is still unfinished. Carrying the reform momentum through the second generation of reforms is essential; reversing course could quickly put all the achievements at risk. It is also vital to fight complacency to ensure that Seychelles does not become a victim of its own success.

With the global economic environment still uncertain, especially in Europe, and given the predominance of tourism in the Seychelles economy and the largely European tourist population, the primary threats to this small, open economy are the fiscal and the external positions. Slower global economic growth could depress domestic growth and tax revenues, but pressures for government spending would likely continue. The fiscal position is still tenuous; public debt is still high and projected to decline only slightly in the medium term though the target for 2018 is 50 percent of GDP. This objective requires keeping the primary surplus in the government budget at about 4.5 percent of GDP for the foreseeable future. So far, current account deficits, although high, have been financed mostly through high FDI, but that flow could quickly reverse if international financial markets deteriorate.

²³ The second generation reforms are being supported by the IMF's Extended Fund Facility (EFF) and the World Bank's Development Policy Operation (DPO). The three-year EFF arrangement (SDR 19.8 million, 182 percent of quota) was extended for one year on December 17, 2012 and access augmented by SDR 6.6 million, 60.6 percent of quota. The DPO is a three-year series for a cumulative amount of US\$21 million.

This situation highlights the need to substantially improve public sector efficiency, enhance private sector competitiveness, invest in human development and public infrastructure (information technology, utilities), and ensure that social protection programs better cushion poor and vulnerable people. Major countercyclical fiscal policy would be difficult to implement if external threats have a substantial impact on Seychelles.

The budget challenges are thus to sustain an adequate tax effort and manage spending prudently. To a great extent, tax revenues depend on two factors. The first is good performance in the tourism sector and the indirect taxes it supports. The second is performance of the private sector in general and the revenue that will be generated as the VAT threshold is lowered. Over the medium term, it is expected that total government revenue will hold steady at about 36 percent of GDP, supplemented by external grants of about 2 percent of GDP. Table 9 shows recent and targeted budgetary outcomes to 2014.

Sustained spending discipline is critical, along with improvements in how public services are delivered. Ensuring that public investments support national priorities is also vital (see box 4.1). There is currently pressure to meet expanding needs for housing, rehabilitate school and health facilities, and continue the capital grants to the PUC, which cannot borrow directly to support its capital program. Over time, however, the private sector could fill a larger share of the housing need, with government involvement targeted to supporting the needy. With improvements in the accounts of some public enterprises (for example, PUC and Air Seychelles), fiscal pressure may be reduced, but monitoring of public enterprises need to be closely monitored in the future.²⁴ Over the medium term, primary current expenditure is expected to be held to at about 25 percent of GDP, the level achieved in 2011 and 2012. Capital expenditure is expected to stabilize between 8 and 9 percent of GDP (it was 11 percent in 2012), to achieve the primary balance of about 4.5 percent of GDP.

Building up public infrastructure is critical for long-term, sustained growth, but the government should not be heavily involved. The PUC and other public enterprises need to be financially independent and able to borrow on their own strength. Similarly, port and airport facilities should be allowed to retain earnings for capital investment and borrow prudently without government guarantees. It is possible to envisage an expansion of port services in a number of ways, such as ship repairs, that have more value added. The industrial zone in Victoria is gradually offering more services and products, especially for the construction trades, and is assembling a variety of products that previously were imported.

²⁴ Creation of the Public Enterprise Monitoring Commission in 2013 is a step in the right direction.

Table 4.1 Budget Outcome and Targets, 2010–14 (Percent of GDP)

| | 2010 Actual | 2011 Actual | 2012 | | 2013 Projected | 2014 Projected |
|------------------------------------|----------------|----------------|-------------|-------------|-------------------|-------------------|
| | | | Program | Actual | | |
| Total revenue and grants | 35.0 | 38.2 | 39.1 | 42.7 | 41.1 | 38.3 |
| Total revenue | 34.1 | 35.8 | 35.9 | 37.2 | 36.9 | 36.2 |
| Tax | 30.1 | 31.8 | 31.6 | 32.3 | 32.7 | 32.5 |
| Non-tax | 4.0 | 4.0 | 4.2 | 4.9 | 4.2 | 3.7 |
| External grants | 0.9 | 2.4 | 3.2 | 5.6 | 4.3 | 2.1 |
| Expenditure and net lending | 32.5 | 35.7 | 37.2 | 41.0 | 39.3 | 36.6 |
| Current expenditure | 27.2 | 27.6 | 28.2 | 29.1 | 29.2 | 27.7 |
| Primary current expenditure | 21.1 | 24.7 | 25.4 | 25.0 | 25.4 | 24.9 |
| Wages | 5.9 | 6.8 | 7.6 | 7.2 | 7.5 | 7.4 |
| Goods and services | 7.2 | 7.6 | 8.0 | 8.2 | 8.0 | 7.9 |
| Transfers | 8.0 | 10.1 | 9.7 | 9.4 | 9.6 | 9.3 |
| Interest payments | 6.1 | 2.9 | 2.8 | 4.1 | 3.8 | 2.8 |
| Capital expenditure ^a | 8.6 | 8.1 | 8.4 | 11.3 | 9.2 | 7.9 |
| Net lending | -3.3 | 0.1 | -0.1 | 0.0 | 0.6 | 0.8 |
| Contingency fund | 0.0 | 0.0 | 0.6 | 0.5 | 0.3 | 0.3 |
| Primary balance | 8.6 | 5.4 | 4.7 | 5.9 | 5.6 | 4.5 |
| Overall balance | 2.5 | 2.5 | 1.9 | 1.8 | 1.8 | 1.7 |

Source: IMF Staff Report, January 2013.

^a Includes contingency fund in 2010–11.

Sustained growth also requires continued stable macro policies, and monetary policy is still a work in progress. The Central Bank's reserve money target was very successful in imposing monetary discipline and pulling back inflation and exchange rates during the crisis. However, now that things are calmer it has become more difficult to use monetary aggregates to anchor inflation expectations, and at times policy interest rates, inflation, and the exchange rate have been unnervingly volatile. To better transmit monetary policy signals, it will be necessary to address the structural excess liquidity in the banking system and promote emergence of an interbank money market. This would give the interest rate a larger role in controlling liquidity and make it possible to gradually substitute reserve money as the nominal anchor with a credible commitment to low and stable inflation.

Steady growth of the economy requires not only sound policies but also diversification in the main economic sectors. The concentration of national exports on only a few markets (in Europe) and products (tourism and fisheries) could cause

further deterioration in both the current account deficit and the fiscal position should the economy again suffer from external crises. Accelerated reforms to increase competitiveness and position the economy to diversify into new markets and new products could make the Seychelles economy more resilient in the medium to long term. Tourism will remain central to the country's medium-term economic prospects. However, the fact that so many tourists come from Europe means that prospects for continued healthy growth depend heavily on what happens in the euro zone, although diversification into non-traditional markets (within and beyond of Europe) will help. Longer term the policy of developing more of the outer islands for tourism will also help. There is also room to enhance tourism revenue by gradually expanding hotel capacity and improving services.

For sustained growth and for Seychelles to reap long-term benefits of the reforms, it will be crucial to improve the business climate to encourage private sector-led growth. Accordingly, over the medium term it is planned to streamline the foreclosure process; speed up the process of obtaining a construction permit and cut the cost; make transfer and registration of property titles more efficient and less costly; introduce online land registration and planning permission applications by linking all relevant agencies; improve access to credit by allowing more flexible use of collateral; reduce the administrative burden on companies to comply with tax requirements; introduce electronic payment options for government services; reduce the number of documents and the time it takes to process imports and exports; and minimize the time, costs, and procedures involved in enforcing a contract.

To ensure a vibrant private sector, the financial sector needs reinforcement and the difficulties enterprises of all sizes have in securing financing must be addressed. Although the authorities and the Central Bank have already done a great deal, the financial sector still suffers from the limited (or reluctant) capacity of commercial banks to serve micro and small enterprises; the lack of incentives for commercial banks to get out of the comfort zone created by investments in high-yield Treasury bills; budding competition among commercial banks; lack of a coherent vision and strategy for integrating the financial sector; and the fact that non-bank finance has been largely untapped (see box 4.2 for an overview of the banking sector).

As the economy evolves toward expanding services exports, growth will depend more heavily on a more qualified and skilled labor force. Despite efforts to promote technical and vocational training, the low percentage of professionals with technical training has led to a skill gap in such sectors as tourism and construction that has been filled in large part by expatriate workers. Seychelles is doing relatively well in terms of school enrollments, but education outcomes are quite poor, partly because

Box 4.1 Public Investment in Seychelles

In Seychelles, state involvement and management of investment in the last decade or so has had mixed results. On the one hand, there have been enormous achievements, such as the airport and the East Coast Land Reclamation Project; on the other, government has crowded out a private mortgage market, and there are persistent difficulties at the Public Utility Company [PUC].

Traditionally capital spending was planned as part of a three-year rolling National Development Plan, which included a list of the investments required by all ministries and government entities. By 1994, the requests amounted to an unrealistic SR 1.5 billion—equivalent to 75 percent of GDP—up from annual public capital expenditures in 1990–94 averaging about SR 220 million a year, 10 percent of GDP. In 1995 the authorities decided to replace the National Development Plan with a rolling three-year public sector investment program (PSIP), which had a shorter list of projects chosen on the basis of affordability and priority. Given the endemic shortage of foreign exchange, priority was given to projects that could earn foreign currency.

Budgeted capital expenditure, after falling to just 7.7 percent of GDP in 1995, crept up in 1998–2000 as a share of GDP to 13.6 percent on average. The rise reflected the launch of a number of ambitious projects. The government also continued to channel funds to public housing, through direct construction and through construction loans to builders and households. Private investments included expansion of the tuna cannery and construction of the Orion Mall and luxury hotels. After 2002 budgeted capital expenditures declined as a share of GDP as the government tried to smooth outlays to relieve its balance of payments and external reserve problems.

The East Coast Land Reclamation Project: The first phase of the ECP had started in 1985 with land close to the Mahé airport; the second phase, begun in 1991, involved the recovery of land north of the airport. The total cost for dredging and other activities was about US\$30 million; official export agencies financed some of the dredging. The third phase of the ECP, launched in 1999, was the largest public sector project in the country's history. It aimed to reclaim 360 hectares off the northeastern coast of Mahé Island, including the new Ile Perseverance, Ile Aurore, Eden Island, and Romainville Island. For the last three islands, the project relied on private sector involvement.

Housing: The constitution enshrines access to housing as a basic right for the Seychellois. The government has always provided some housing; a recent estimate indicates that out of a stock of 28,000 units, the government rents 4,750 units (about 17 percent). About 66 percent of the private housing units in the country are owner-occupied and the rest are rentals. Since 2008, the main public housing project, on Ile Perseverance, is to build about 2,050 units; through 2011 478 units had been completed and assigned.

The Public Utility Company: PUC has long received capital grants from the budget because its own revenues barely covered operating costs. Delays in passing on to consumers the increases in fuel costs since 2008 have squeezed PUC margins. In 2011 and 2012, electricity tariffs for commercial users were raised significantly, but increases for households were capped at a cumulative 15 percent. The water sector, the pipes of which need substantial upgrading to cut down on water losses, will benefit in 2013–17 from European Investment Bank loans of about US\$40 million, with accompanying technical assistance. A seven-year phased rebalancing of household and commercial tariffs to achieve a more efficient energy market, is scheduled to start in 2013.

there is little incentive for good teachers (including foreigners) to stay in the system. It will be critical to enhance educational facilities.²⁵ Education, including education beyond skill development, is among the highest priorities in the Seychelles.

²⁵ Results of exams for the Cambridge International General Certificate of Secondary Education (IGCSE) are not good, particularly in science.

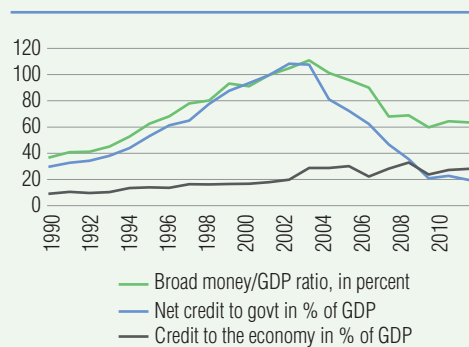
Box 4.2 Banking Sector Developments

The Seychelles banking system comprises seven commercial banks; the state-controlled Development Bank of Seychelles (DBS); the state-owned Seychelles Savings Bank; and the state-owned Housing Finance Corporation (HFC). Total deposits at the end of 2011 were SR 6.9 billion, 55 percent of GDP; broad money, including currency in circulation, constituted 60 percent of GDP. The ratio of broad money to GDP (bank deposits and currency in circulation) rose steadily through the 1990s and peaked at 110 percent at the end of 2003 (Figure A), because of large government deficits in the 1990s and increased bank holdings of treasury bills, imposed by the government through a liquidity ratio. The broad money–GDP ratio then fell to about 68 percent at the end of 2007, as the government debt held by commercial banks and the Central Bank fell. The devaluation in 2008–09, which accelerated inflation, brought the ratio down by another 10 percentage points.

As a share of GDP, net bank credit to the government from the Central Bank and commercial banks grew steadily through the 1990s, reaching 105 percent in 2002–03 as the government established a liquidity reserve requirement that banks had to meet by purchasing T-bills. This requirement was raised in 1998 to 70 percent of deposit liabilities. Liberalization in 2002–03 and reduction of the deficit rapidly reduced the government paper held by banks as government domestic debt fell. Credit to the economy as a share of GDP grew steadily through the 1990s and 2000s but peaked at just 33 percent of GDP in 2008 (Figure B)—low in relation to other middle-income countries. After the devaluation of 2008, the ratio declined.

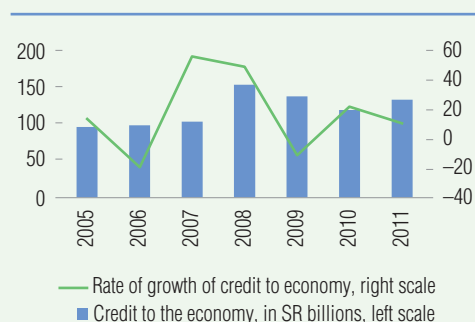
Traditionally, the high exposure of banks to government securities undermined their incentives to cut lending rates (as did prudent lending standards). With devaluation in November 2008 and the following months, and the concomitant surge in interest rates on T-bills rates to above 20 percent, bank profits also surged. By mid-2009 the T-bill rate had fallen below 10 percent and slid further to below 5 percent in 2010 as the government budget balance moved to surplus and far fewer T-bills were issued. In these circumstances, it was natural that banks would become more active in lending to businesses and households. To protect their margins in 2010 and 2011, banks were reluctant to cut the lending rate, which declined only slightly, from 12 percent at the end of 2010 to 11.3 percent a year later (a rate equivalent to almost 8 percent in real terms). Credit to the economy, which peaked in 2008 (Figure B), shrank in 2009. Although it reversed in 2010 and 2011, by the end of 2011 it was only 18 percent above the amount at the end of 2008, while nominal GDP had risen by 39 percent.

Figure B4.2.A GDP, 1990–2011



Source: Central Bank of Seychelles.

Figure B4.2.B Credit to the Economy, 2005–11



Source: Central Bank of Seychelles.

To meet the economy's human resource requirements, Seychelles promotes vocational, managerial, and service skills, and since 2008 it has emphasized early childhood development and tertiary education. Among immediate tasks the country needs to undertake are better utilizing teachers by increasing current pupil-to-teacher ratios; reviewing current limits on class size; increasing teacher-pupil contact hours; and minimizing teacher absenteeism. In the medium term, priorities are to make education planning, policy, and management more efficient and effective, and set up an education management information system. Gradual expansion of secondary and tertiary facilities and those for professional qualifications are envisaged, with private participation.

A first-class health system is also critical to a robust labor force. Seychelles has significant achievements in the health sector and has largely achieved the Millennium Development health goals.²⁶ Over the years, Seychelles has built up a robust network of primary care facilities and has achieved virtually universal coverage of services, which are accessible to the community. Facility-based services are complemented with school health program and home visits. However, while the constitution grants free access only to primary care services, in practice *all* services are provided free of charge, raising questions about long-term fiscal sustainability and efficiency.²⁷ While the number of patients treated abroad is declining, the cost per overseas treatment is increasing.

There is room to both improve the system and reduce costs by, for example, reinforcing the referral system between the satellite health centers and regional centers; task-shifting—specifically, allowing nurses to provide basic services at the lower level; and defining the service package to be provided at the different levels of service delivery. Another challenge is that recently, noncommunicable diseases, injuries, and mental health problems have been the main causes of death. Contraceptive use is low, teen pregnancy is a major issue,²⁸ and the prevalence of

²⁶ Infant mortality was 14 per 1,000 live births, and for many years, Seychelles has recorded zero maternal mortality. Skilled health personnel attend close to 100 percent of births, and over 99 percent of women receive prenatal care.

²⁷ “The state recognizes the right of every citizen to protection of health and to the enjoyment of the highest attainable standards of physical and mental health, and with a view to ensuring the effective exercise of this right, the state undertakes: a) To take steps to provide for free primary health care in state institutions for all its citizens; b) To take appropriate measures to prevent, treat and control epidemic, endemic and other diseases; c) To take steps to reduce infant mortality and promote the healthy development of the child; d) To promote individual responsibility in health matters; e) To allow, subject to such supervision and conditions as are necessary in a democratic society, for the establishment of private medical services” (Article 29, Constitution of the Republic of Seychelles, pp. 33–34, 1994).

²⁸ Thirty-two percent of all first pregnancies occur among those aged 15–19.

HIV-AIDS continues to rise. Private health services may expand alongside public services over the longer term.

Improving efficiency and governance will enhance the social protection system. Recently, policy and institutional changes, supported by better information technology, have improved governance and efficiency. Now Seychelles plans to streamline and tighten disability benefits and reduce incentives to remain listed as disabled. Although comprehensive and generous social protection and assistance helps the population respond to both aggregate and individual shocks and cushions the poor effectively against economic hardships, the system's efficiency and sustainability could improve through tighter monitoring, reduced discretion, and better targeting. Seychelles also has to tackle the long-term fiscal risks of its pension system, which are related to its generous benefits and limited contributions. This issue can be addressed by a combination of measures, such as a gradual increase in the contribution rate and refinement of the benefit formula and conditions for qualifying.

Reducing price distortions and ill-targeted subsidies and fostering competition will help build up the housing finance sector. There is significant overlap between the Housing Finance Corporation (HFC) market and that of private financiers. Considering HFC's subsidized interest rates, the overlap means consumers are not motivated to see home financing from the private sector, so the private sector is not motivated to provide it. Consumers also face affordability problems: only 5 percent of households earn the requisite SR 15,000–20,000 a month required to access mortgage financing of SR 750,000–SR 1,000,000. Housing finance policies should target service to the vulnerable (for example, the aged, those unable to secure employment, and disabled people); low-income households (such as those headed by single parents and people in very low-wage employment); and middle-income, first-time homebuyers (such as double-income young couples wishing to purchase their first home).

Recent exploration for oil has mainly confined to acquiring seismic data. If exploration succeeds and exploitation takes off over the next five to seven years, the impact on the small Seychelles economy (GDP of about US\$900 million) would be dramatic. Government revenue generated from the royalties and taxes of a single petroleum project could range from US\$500 million to US\$2 billion annually for 10–15 years. Seychelles has started to put in place the necessary structures and frameworks for managing oil revenues, including legal and fiscal. The government also intends to commit to transparency by adopting the Extractive Industry Transparency Initiative (EITI) principles. Longer term, when oil production starts, the dynamics of the economy may change.

Overall, keeping to a satisfactory growth path will require a careful balance between prudent budgetary policy and support for priority investments in a climate

conducive to active private sector involvement and risk-taking. Although the path may not be easy, eliminating the exchange and trade restrictions that prevailed before the reform of 2008, resolution of the debt overhang, and closer integration with the world economy all enormously increase the chances that Seychelles can move forward successfully. The Seychelles experience constitutes an example of how eliminating restrictive policy regimes, adopting sound macroeconomic policies, and moving forcefully on structural reforms can unleash energies and revive prospects for economic growth relatively quickly.

5

Lessons from the Seychelles Experience

The secret of the successful Seychelles reform was the very high degree of ownership of the reform package and the coherence and speed at which the complete package of reforms was put in place.

One of the major lessons learned is that reform is painful and ultimately the economy must be brought back to economic fundamentals. That is why it is preferable that crises be prevented by adherence to prudent fiscal and debt policy and by moving early to address any structural impediments to long-term sustainability.

If a crisis does arise, it should be used as an opportunity to do as much as possible as soon as possible. Delaying reforms will only cause more damage. Dragging out major changes once the heat is off will compromise any hard-won gains.

Another important lesson is that the results are seen only when the critical mass of reforms is completed. The benefits are not a linear function of reform. Incremental reforms made slowly are difficult to sustain because results are not visible, so political support fades with time.

Another key lesson is that even when their fiscal trajectories are unsustainable, countries can still find financial intermediaries willing to help them—but they need to be careful when trying to fill big holes not to dig bigger holes.

A combination of factors and policy measures made the Seychelles transition from crippling debt to economic stability a success—among them clear objectives and priorities, leadership and political commitment, support of both stakeholders and the people of Seychelles, evidence-based policy making, and assistance from multilateral institutions and the donor community. The following sections distill lessons learned from the way the crisis built and the subsequent reforms in Seychelles.

Assess the situation realistically and design a complete reform package: The reforms worked well because the new program was clearly based on an accurate assessment of the situation. The authorities and agencies like the IMF and the World Bank had a solid basis of actual facts to work with. This permitted a careful, realistic

evaluation of economic problems and possible solutions. The evidence made it possible to target the most important problems immediately and pursue solutions in a coherent and coordinated way.

In the Seychelles this approach meant, among other things, that fiscal policy had to be completely recast to generate a large primary surplus and support a float of the currency, which was necessary to achieve a real depreciation, anchored by a new and untested monetary policy. Unlike earlier partial reforms, in this instance the authorities worked first with a team of experts from the IMF and later from the World Bank and other partners as well to put in place a comprehensive package of measures.

Build strong ownership and explore homegrown solutions through partnerships and communication: It is critical that all the players support reform. The political hierarchy, the top technical people within the state apparatus, and the most influential members of the private sector must understand the necessity of the reform program and offer unconditional support. Only when all the political elements are convinced of the need for reform and the value of the action plan, is it possible to get the public fully on board and support galvanized. And only then will the planned actions be supported and defended. That synergy is often achieved through dialogue, participatory planning, and well-articulated implementation and monitoring of reforms.

In Seychelles, President James Michel, then-Finance Minister Danny Faure, and other prominent persons were fully committed to complete reform. Each and every reform measure, no matter how small, was carefully explained to as many people as possible. When measures were to be announced was also thought through carefully. As soon as decisions were taken but before they led to action, signals were given about what would happen, followed by formal announcement about the details. This process allowed the population to anticipate and plan accordingly and kept expectations realistic. It is far preferable to under-promise and over-deliver than over-promise and under-deliver.

Call in international experts for assistance: In asking how to get out of a crisis, important related questions are what and how much to do—and whether whatever is done will eventually lead to better economic conditions. Institutions like the IMF and the World Bank can draw on experiences with other countries that can help to build confidence that reforms will work.

As soon as they realized Seychelles needed support to recover from decades of failed policies, the authorities held frank discussions first with the IMF and soon afterward with other partners. Although there was considerable skepticism in the international arena, the IMF became a forceful advocate, and its advocacy rallied support from other partners.

The IMF provided extensive technical support on the monetary, exchange, and financial supervision; management of public debt; and debt restructuring. Significant technical assistance on tax administration, tax policy reform, and public financial management also proved valuable. The support was so extensive that some thought it was excessive. The IMF had a technical and financial assistance package, covering a range of monetary and financial issues, long before the reforms were launched, and it had people on site for the currency float. The main banks were stress-tested before the reforms to ensure that the financial system would survive the transformation. The World Bank provided assistance to clarify how the public expenditure system functioned and worked with the authorities to improve governance and efficiency. The authorities also benefited greatly from lobbying by other partners, which helped attract international support.

Seychelles found multilateral institutions almost indispensable in fostering support for its reforms and for debt restructuring. Often external creditors require a third-party assessment before they agree to requested conditions. In fact, the most important consideration is to ascertain whether the reforms will succeed in laying the foundation for debt sustainability.

Multilaterals also help raise credibility locally level. The public is comforted to see large organizations associating themselves with a reform. The technical input from such organizations is also an element that helps to build local skills as well as local foster ownership. In challenging economic times, having local staff trained in public finance and macroeconomic management can ensure not only good performance but sustained initiative and agility.

Support technical staff and encourage teamwork: Reforms must be championed, and those willing to stick their necks out need to be supported and applauded. Initially reforms usually require structural changes, followed by institutional changes. Institutional change is often the more difficult; in some organizations reformers need to tackle influential senior personnel and in others the way business is conducted.

In the end, all changes proposed must be consistent with the country's macroeconomic reform program and with the need for financial stability and fiscal prudence. It may seem simpler at the most senior level to ease into tackling professional incompetence, corruption, or misconduct or simply ignore what may be wrong—but taking the easy course will erode the technical drive to lead change and thus undermine reform efforts and ultimate success.

Those implementing reforms must be motivated, well trained, and fully familiar with their responsibilities. Reform means change, and change demands extra energy to maintain forward momentum and fight the temptation to fall back on

old practices. Energy for reform can be sustained only if all of those charged with getting change through operate in harmony and complement one another's efforts. Teamwork matters particularly at the institutional level to ensure that messages related to reforms are consistent.

In seeking debt relief, keep the process transparent and make sure that the burdens are shared equitably: To convince creditors about the need for debt “hair-cuts,” equitable treatment of all is vital. No creditor wants to sacrifice for another creditor. One point to be made is that although creditors lose an asset, the borrower is also making a sacrifice (the reform process itself), and thus all parties can be assured of a better future.

In fostering trust and encouraging debt relief, it is crucial that for all creditors be aware of how other creditors are being treated. Countries are encouraged to release to the public the terms of renegotiated loans and to ensure consistency in how successor conditions are applied.

The 2008 financial crisis remind everyone in the financial world and beyond of stark realities, such as the limited options open to countries stricken by a debt overhang. Seychelles, with a debt-to-GDP ratio of almost 150 percent, and much of its debt owed to non-Paris Club creditors, was a clear demonstration of willingness to compromise on the part of all parties.

Obviously, it is possible to make the case for writing off some debt and re-scheduling the balance, but the story underpinning that case must be credible. Ultimately all institutions make decisions to minimize their losses. The Seychelles experience with sovereign debt restructuring has made it possible today to present options that are well-supported, particularly by multilateral creditors, and backed by a borrower's proven record of reform.

The world's large institutions, among them the Paris Club, understand and support heavily indebted countries that have the will to undertake real reform and are committed ultimately to debt sustainability. For instance the Paris Club applied the Evian Approach, which had not traditionally been applied to middle-income countries like Seychelles. The support of multilateral institutions—the IMF, World Bank and the African Development Bank—was vital in paving the way for the Paris Club to write off 45 percent of Seychelles' debt.

I warmly welcome this telling of Seychelles' remarkable transformation since 2008 from a highly distorted and restricted economy in crisis to an open, prosperous, market economy. This success story merits being told as it has many useful lessons for other countries facing daunting reform agendas. Seychelles' macroeconomic reform success is remarkable—it must be one of the fastest, most comprehensive, and most successful transformations in modern history. As IMF mission chief from mid-2008, when discussions on a comprehensive reform strategy were initiated, through early 2010, I found a government that desperately wanted to be free from the legacy of large macroeconomic imbalances but did not quite know exactly what to do or how much to do, and without confidence that they would succeed. The IMF, the World Bank, and other agencies brought global expertise and experience, but the very high degree of ownership of the reform package and the determination of the Seychellois leadership is, in my eyes, the secret of the Seychelles reform success.

I look back with fondness to the collaborative and open relationship with the Seychelles authorities that helped produce these results. And I wish the people of these uniquely beautiful islands continued success and prosperity.

Because of the global financial crisis of 2008, sovereign debt in the Eurozone, and the economic slowdown in emerging markets, standard macroeconomics is being questioned throughout the world. There is a vigorous debate on whether austerity or stimulus is the best way to help countries with large debts. Because this book tells the story of how one country, Seychelles, recovered from a debt crisis by following orthodox economic policies, it could be seen as taking a position on the current debate. But the book also shows that Seychelles' success was not simply due to the policies the country adopted. The program had strong ownership at the highest levels. The government consulted widely with the public before putting reforms in place. There was judicious use of outside technical assistance in designing the policies. And the program was both coherent and courageous—it didn't go half-way—so both creditors and citizens knew that the government was serious.

In short, the Seychelles story adds much-needed nuance and texture to the debate about macroeconomic policies in developing countries. That it is told in a compelling and engaging manner makes it a pleasure to read and a joy to learn from.



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