SEYCHELLES

How C ssic Policies Restored Sustainability

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The Republic of Seychelles

World Bank

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

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,

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Abbreviations and Acronyms

BADEA	*Banque Arabe de Développement Economique en Afrique* (Arab Bank for Economic Development in Africa)
COI	Conserverie de l'Ocean Indien
COSPROH	*Compagnie Seychelloise de Promotion Hotelière, Ltd.*
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 W

Debt-Promoting Economic

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

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 (able 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
[illegible]	0.1	704.7	0.6	0.3	1.4	1.2
GD[illegible] ($)	8,404	505	5,609	10,000	8,603	4,588
N[illegible] (% [illegible])	99		68	92	89	89
[illegible]-5 [illegible] 1,000)	15	171.2	17.4	19	30	16
NDP HDI [illegible] 173 [illegible])	36		73	47	62	77
L[illegible]	73	45	74	76	68	72

[illegible] IMF, [illegible] NDP.

ECC[illegible] = E[illegible] [illegible]

[illegible]

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. Tunding 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.

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 afthe 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 imtheir 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).

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

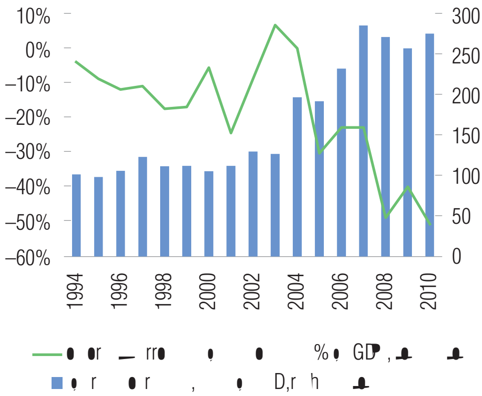
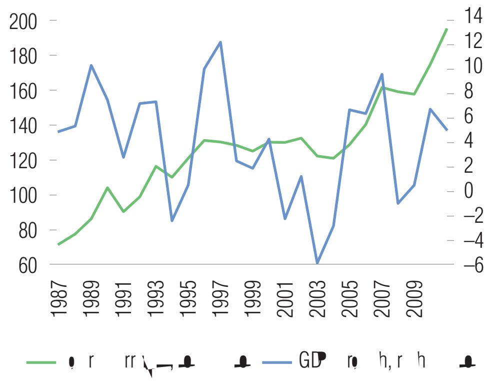


Figure 1.4 Tourist Arrivals (000s) and GDP Growth Rate (%), 1987–2010



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.

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 at1

Table 1.2 External Government Arrears (US$ millions)

	2001	2002	2003	2004	2005	2006	2007	2008
[illegible]	53.9	81.4	104.1	136.6	184.2	123.5	162.5	316.7
[illegible]	13.1	25.2	33.3	39.6	57.7	0.3	3.0	0.0
[illegible]	10.0	20.2	27.3	30.9	48.9			
[illegible]	0.0	0.5	0.8	1.5	0.9			
[illegible]	3.2	4.5	5.2	7.2	7.9	6.6		
[illegible]	34.2	50.1	56.8	79.8	103.5	103.8	134.9	178.8
[illegible]	33.2	46.7	49.5	67.9	79.6	100.2	119.8	121.8
[illegible]	1.0	3.4	7.3	11.9	23.9	3.6	15.1	56.9
[illegible]	6.2	6.1	14	17.1	22.9	19.4	24.6	137.9
[illegible]						19.4	24.6	15.6
[illegible]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	122.3
[illegible] GDP (%)	48.7	51.9	52.4	54.3	44.0	51.4	71.9	79.2
[illegible] GDP (%)	8.6	11.7	14.8	19.5	25.5	14.8	14.8	14.8
[illegible] GDP [illegible]						1037.6	1038.8	957.6

[illegible]: IMF [illegible].

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 program[7] 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 Memorandu discoconomic and SectMew (r)14.9(a577ong with)14.9rrd ande at TJT 0ctaf paim0,1

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 gov-

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
B r [illegible]	21.1	18.5	43.0	16.5	14.0
E [illegible]	24.3	43.7	21.3	17.3	0.0
F [illegible]	26.7	22.5	43.0	16.0	10.0
M [illegible]	33.3	3.0	24.8	67.5	5.0
M r [illegible]	28.2	33.0	38.8	12.8	13.0
Seychelles	**36.1**	**29.8**	**29.3**	**21.5**	**15.3**
[illegible]	36.6	31.7	36.0	16.0	15.3
Group average	**29.5**	**26.0**	**33.7**	**23.9**	**10.4**

[illegible], 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.

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 nonexistent, 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 correspond-

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.

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

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

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

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 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.

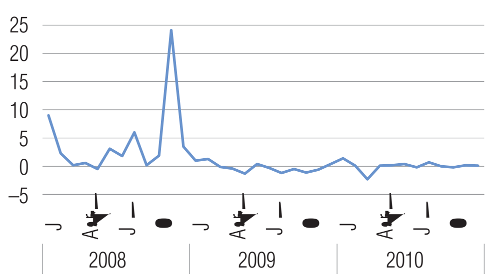
3

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 (ont on ont)



[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 were strictly limited to preventing exceptional

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, educs3us,e andwelfauret rnsferls. The wngebtill-
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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

	2009		2010	
Product	GST	Trades Tax	GST	Trades Tax
[illegible]	2.0	0	2.0	0
[illegible]	2.0	6	4.0	4
[illegible]	2.0	6	4.0	4
[illegible]	2.0	6	4.0	4
[illegible]	2.0	6	4.0	4
[illegible]	0.5	0	0.5	0
[illegible]	1.0	3	0.5	3

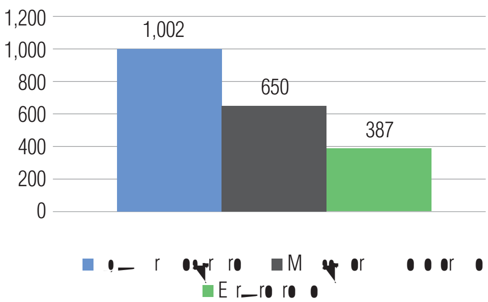
[illegible]

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 per-

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 ex-

Figure 3.6 Government Personnel Reductions, 2008–09
(Percent of Po t on)



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

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 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

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 budenterprises. 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]

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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$25 million shareholder loan on aas-needed basis. For its part, the Seychelles government assumed liabilities to domestic banks and suppliers equivalent to US$ 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 has 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

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

	2010 Actual	2011 Actual

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

Box 4.1 Public Investment in Seychelles

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.

Box 4.2 Banking Sector Developments

Figure B4.2.A GDP, 1990–2011

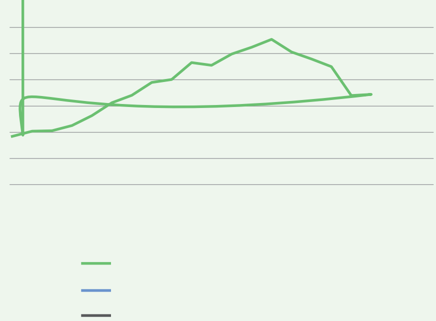


Figure B4B2.A

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

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 necessaebumtakes I(v)4.9(ke eearnnl 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

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 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:

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 "haircuts," 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.

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. is 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 con - dence that they would succeed. e 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.

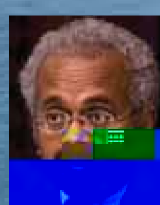
I look back with fondness to the collaborative and open relationship with the Seychelles authorities that helped produce these results. And I wish the people of these uniquely beautiful islands continued success and prosperity.

Because of the global nancial crisis of 2008, sovereign debt in the Eurozone, and the economic slowdown in emerging markets, standard macroeconomics is being questioned throughout the world. ere 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. e program had strong ownership at the highest levels. e government consulted widely with the public before putting reforms in place. ere 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. at it is told in a compelling and engaging manner makes it a pleasure to read and a joy to learn from.

Paul Mathieu

Advisor, Monetary And Capital Markets, International Monetary Fund



Shanta Devarajan

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THE WORLD BANK