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August 5, 1983

To: Members of the Executive Board
From: The Acting Secretary
Subject: Seychelles - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Seychelles, which will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Egwim (ext. 76031) until August 11, 1983 or Mr. Jimenez (ext. 73707) thereafter.

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INTERNATIONAL MONETARY FUND

SEYCHELLES

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983
Consultation with Seychelles

Approved by Oumar B. Makalou and W.A. Beveridge

August 4, 1983

I. Introduction

The 1983 Article IV consultation discussions with Seychelles were carried out by a mission which visited the Seychelles during the period June 4-16, 1983. The Seychelles representatives included Mr. Guy Morel, Principal Secretary of the Department of Finance and Governor of the Central Bank of the Seychelles; Mr. Robert Grandcourt, Permanent Secretary of the Ministry of Planning; Mr. G. Payet, Permanent Secretary, Ministry of National Development; Miss Y. Lafortune, Permanent Secretary, Ministry of Labor; Mr. Tin Tun, General Manager of the Central Bank of the Seychelles; and other officials. The staff representatives were Messrs. J. Jiménez (head), J. Simpson, J. Bové, and C. Egwim and Miss M. Duane (secretary), all of the African Department.

Seychelles has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II. Background to the Discussions

The Republic of the Seychelles is a small archipelago located in the Indian Ocean, comprising about 100 islands, with a total area of 443 square kilometers and a population of about 65,000. The economy is heavily dependent on tourism, which, together with related activities, accounts for about half of GDP, over two thirds of foreign exchange receipts, and about one third of formal employment. The growth of tourism can be traced to the opening of the international airport in 1971. Tourist arrivals expanded from 15.2 thousand in 1972 to 78.9 thousand in 1979. As a result of this rapid growth, the economy suffered various structural changes. There was a transfer of labor from the agricultural sector, an increased dependence on imports, and a more rapid rise in

domestic prices as the demand for labor, goods, and services was exacerbated by the rapid growth in tourist arrivals and the necessary capital investments in the tourist industry. During the period 1976-79 the economy expanded at an average annual rate of about 9 per cent in real terms. Particularly noticeable in this period was the relative decline in agricultural activity and exports, with the share of agricultural employment dropping significantly. There has also been a rapid increase in food imports to match the dietary requirements of tourists, and the availability of foreign food items also led to a change in domestic food preferences. The rising proportion of imports in domestic consumption, which made the economy more vulnerable to the impact of world inflation, the depreciation of the currency between 1976-81, and expansionary domestic policies contributed to an acceleration in the rate of growth of domestic prices. Between mid-1976 and mid-1981 the cost of living rose by an annual average of about 14 per cent.

In 1977 the present administration took power and soon after adopted an ambitious program aimed at economic diversification away from the tourist sector and the establishment of greater social equity. The Government promoted a rapid increase in wages (leading to a rise of 245 per cent between 1978 and 1981), and greater emphasis on agricultural and industrial investments and social expenditure, in some cases through public enterprises. The attempt to restructure the economy has resulted in an increase in the number of public enterprises and sociopolitical organizations as well as a more active public sector stance in economic matters.

By 1979, when tourist arrivals reached their highest level, it had become obvious that the tourist industry had expanded too quickly, was fraught with inefficiencies, but was generating substantial profits. Moreover, the inability of the industry to take care of the large number of visitors properly was also leading to a decline of the reputation of the Seychelles as a tourist destination. As tourist income began to decline, real GDP contracted by about 11 per cent between 1979 and 1983.

Concurrently with the initial implementation of the Government's reforms, the world economic situation worsened following the period 1979-80 with a markedly negative impact on the Seychelles. The recessionary conditions in many of the Seychelles' tourist markets led to a decrease in demand for tourist services, which was further aggravated by the rapid increase in air fares, particularly for long-distance destinations like the Seychelles. The latter was an especially negative factor, as about 50 per cent of tour prices are accounted for by the cost of the air fare. Moreover, to reverse a previous depreciation and in an attempt at containing price increases, in March 1981 the authorities revalued the Seychelles rupee upward against the SDR (to which it is

linked) by 15 per cent. Even though purely domestic costs form a small proportion of the cost of tours to the Seychelles, the increase had a negative impact on tourism.

Following the revaluation of the rupee, the existing price controls were strengthened to ensure that the benefits were passed on to consumers. In effect, price trends have ameliorated, with prices rising by only 0.3 per cent per year in the two years ending March 1983. The deceleration of price pressures allowed wage increases to be minimized in this period.

The growth of parastatal organizations has been a major element of policy in the Seychelles since 1980. Presently about 32 parastatal organizations are operating. Apart from the utilities, some are involved in trading, with monopolistic positions, while others are involved in the production of goods and services. The latter have been established in part to take advantage of possibilities which have been ignored by the private sector in its overconcentration in the tourist sector and in part to continue operations of businesses abandoned by the private sector. Although most enterprises are now providing some financial information to the Ministry of Finance, there is a great divergence in its quality, which does not permit the drawing up of overall public sector accounts. Less than adequate review of their financial positions is taking place, with policy actions being taken on an ad hoc basis without reference to the overall position of the public sector and its impact on the economy. At the present time the only available measurement of the activities of public enterprises is through the resources provided by the Central Government, 1/ their foreign borrowing and their utilization of domestic bank credit (Table 1). These data indicate that their overall deficit rose rapidly from SR 22 million in 1979 to SR 98 million in 1982, or from about 3 per cent of GDP to 10 per cent, and stayed at a high level since then. The bulk of the financing has been provided by the Government, to a large degree from the Social Security System, in the form of net lending and transfers, although bank credit became increasingly utilized after 1981. Consequently, the operations of the Central Government have been greatly affected by the support granted to the public enterprises. Including the net lending and transfers, the overall budget deficit rose from under 8 per cent of GDP in 1979 to under 12 per cent in 1982. Net lending and transfers averaged about 5 per cent of GDP between 1979 and 1982. Excluding net lending transfers to the public enterprises, the Government generated an overall deficit equivalent to only about 4 per cent of GDP in 1979-82, which was financed largely from

1/ Including the Social Security System, which has been consolidated with the budget.

abroad. Central Government revenue and grants rose by about 73 per cent between 1979 and 1982 or from 34 per cent of GDP to 48 per cent (see Attachment II). Expenditures including net lending and transfers to the public enterprises rose from 39 per cent of GDP to 54 per cent during the same period.

Table 1. Seychelles: Estimated Overall Deficit of Public Enterprises, 1979-1983

	1979	1980	1981	1982	1983 Proj.
<u>(In millions of Seychelles rupees)</u>					
Total borrowing by public enterprises	22.3	62.6	98.4	97.7	80.0
Domestic financing	22.3	43.9	96.0	85.8	80.0
Budget	22.3	33.5	73.6	49.5	73.8
Net lending	(0.5)	(2.0)	(69.4)	(31.4)	(64.3)
Transfers	(21.8)	(31.5)	(4.3)	(18.1)	(9.5)
Bank financing	--	10.4	22.4	36.3	6.2
Direct foreign borrowing	--	18.7	2.4	11.9	--
<u>(As a percentage of GDP)</u>					
Total borrowing	2.8	6.6	10.4	9.9	8.1

Sources: Data provided by the Seychelles authorities; and staff estimates.

The consolidated overall public sector deficit (Table 2) rose from an average of under 4 per cent of GDP in 1979-80 to 16 per cent in 1982. In 1981-82 substantial bank financing was utilized, equivalent to an average of over 15 per cent of the initial money and quasi-money stock, with a considerable expansionary impact. Foreign loan financing of public sector operations has been large, averaging 9 per cent of GDP in the three years 1980-82, with grants equivalent to an additional 8 per cent of GDP per year.

Tourist income reached its highest level in 1980, when it was equivalent to SR 326 million, or 61 per cent of imports. While the trend of tourist earnings was rising, the balance of payments was generally in surplus, and an important amount of foreign assets was accumulated. In 1981-82 an overall balance of payments deficit was recorded (Table 3). Including changes in commercial banks' net foreign assets, the balance of payments recorded an average annual deficit of about SR 48 million, or 10 per cent of imports. The main cause for the weakening of the balance of payments has been the rapid decline in tourist income, which fell from its peak of SR 326 million in 1980 to only SR 220 million in 1982. In addition, export earnings, although accounting for only a small proportion of overall foreign exchange earnings, have also fallen, from SR 36.1 million in 1980 to SR 25.6 million in 1982. The shortfalls in foreign earnings would have led to larger balance of payments deficits had not the level of imports remained unchanged during this period, with a larger proportion being financed through official grants and foreign capital inflows. As part of the overall deficit was financed by the commercial banks and by foreign borrowing of the Central Bank, the gross reserve level of the Central Bank fell only from the equivalent of almost three months' imports to under two months' by 1982.

In November 1979 the Seychelles rupee was pegged to the SDR at SDR 1 = SR 8.3179. Previously it had been pegged to sterling at a rate of SR 1 = £ 0.075. From November 1979 through December 1980 the real effective exchange rate of the Seychelles rupee depreciated by 11 per cent, with important domestic inflationary repercussions, given that imports are equivalent to 66 per cent of GDP. The exchange rate was revalued in March 1981 by 15 per cent to SDR 1 = SR 7.2345. On the basis of this action, the real effective exchange rate appreciated by 20 per cent between December 1980 and September 1981, more than offsetting the previous depreciation. Since then the real effective exchange rate has depreciated. At the end of March 1983 the real effective exchange rate index totaled 101.7 compared to 100.2 when the rupee was first pegged to the SDR and a base of 100.0 for December 1976 (Table 4).

Table 2. Seychelles: Estimated Overall Deficit of the Public Sector, 1979-1983

	1979	1980	1981	1982	1983 Proj.
<u>(In millions of Seychelles rupees)</u>					
Public sector overall deficit	60.6	91.5	112.1	160.5	133.1
Central Government (net)	38.3	28.9	13.7	62.8	53.1
Central Government deficit	(60.6)	(62.4)	(87.3)	(112.3)	(126.9)
Minus transfers to public enterprises	(-22.3)	(-33.5)	(-73.6)	(-49.5)	(-73.8)
Public enterprises financing requirement	22.3	62.6	98.4	97.7	80.0
Financing	60.6	91.5	112.1	160.5	133.1
Domestic (net)	10.0	15.8	62.5	40.2	59.2
Banking system	(9.8)	(15.8)	(50.6)	(44.6)	(59.2)
Other	(0.2)	(--)	(11.9)	(-4.4)	(--)
Foreign (net)	50.6	75.7	49.6	120.3	73.9
<u>(As a percentage of GDP)</u>					
Deficit	7.5	9.6	11.8	16.3	13.1
Central Government (net)	4.8	3.0	1.4	6.4	5.2
Central Government deficit <u>1/</u>	(7.5)	(6.6)	(9.2)	(11.4)	(12.5)
Public enterprises	2.8	6.6	10.4	9.9	7.9
Financing					
Domestic (net)	1.2	1.7	6.6	4.1	5.8
Foreign (net)	6.3	7.9	5.2	12.3	7.3

Sources: Data provided by the Seychelles authorities; and staff estimates.

1/ Including social security system.

Table 3. Seychelles: Balance of Payments, 1978-83

(In millions of Seychelles rupees)

	1978	1979	1980	1981	1982 Prel.	1983 Proj.
Current account balance	<u>-44.0</u>	<u>-106.0</u>	<u>-137.8</u>	<u>-165.1</u>	<u>-297.1</u>	<u>-322.9</u>
Merchandise trade	-314.2	-411.0	-498.6	-469.8	-515.2	-565.0
Exports, f.o.b.	(46.1)	(39.5)	(36.1)	(29.4)	(25.6)	(20.0)
Imports, f.o.b.	(-360.3)	(450.5)	(-534.7)	(-499.2)	(-540.8)	(-585.0)
Services (net)	204.3	259.9	281.7	247.4	185.6	157.0
Of which: tourism income	(243.0)	(291.0)	(326.0)	(285.0)	(220.0)	(220.0)
Transfer payments	65.9	45.1	79.1	57.3	32.5	85.1
Capital account balance	<u>48.6</u>	<u>67.9</u>	<u>103.2</u>	<u>65.2</u>	<u>134.3</u>	<u>95.8</u>
Private investment (net)	20.0	18.4	26.4	13.8	14.3	20.0
Official loans (net)	18.3	50.6	75.7	50.3	120.0	75.8
Commercial banks' capital	10.3	-2.3	--	--	--	--
Allocation of SDRs	--	1.2	1.1	1.1	--	--
Short-term capital and errors and omissions	<u>-14.9</u>	<u>34.9</u>	<u>81.2</u>	<u>52.0</u>	<u>102.1</u>)	<u>(-227.1)</u>)
Overall balance	<u>-10.3</u>	<u>-3.2</u>	<u>46.6</u>	<u>-47.9</u>	<u>-60.7</u>)	
Change in banking system reserves (increase -) <u>1/</u>	10.3	3.2	-46.6	47.9 <u>2/</u>	60.7	...
<u>Memorandum item:</u>						
Short-term capital and errors and omissions and change in banking system reserves	4.9	38.1	34.6	86.5	162.8	227.1

Sources: Data provided by the Seychelles authorities; and staff estimates done in conjunction with the Central Bank of Seychelles.

1/ Corresponds to foreign exchange assets held by the public sector.

2/ Unadjusted for a revaluation loss of SR 13.4 million.

Table 4. Seychelles: Real Effective Import-
Weighted Exchange Rate, December 1976-March 1983

(Index 100 = 1976)

Period	Rate
1976 December	100.0
1979 December	100.2
1980 December	88.8
1981 March	101.0
June	106.1
September	107.1
December	100.6
1982 March	100.4
June	101.4
September	100.3
December	104.4
1983 March	101.7

Sources: Data provided by the Seychelles authorities;
and staff calculations.

Total outstanding external debt of Seychelles has risen from 17 per cent of GDP in 1980 to a projected 40 per cent of GDP in 1983. However, due to the concessionary nature of most of the loans, the debt service ratio is not anticipated to exceed 6 per cent in 1983 but will remain under 10 per cent in the foreseeable future on the basis of 1983 outstanding foreign debt.

III. Report on the Discussions

1. Introduction

As 1982 ended, the Seychelles faced mounting public sector deficits, declining growth rates, and substantial balance of payments pressures, with a rapidly declining foreign exchange earning capability. There was also a public sector which had grown very rapidly and appeared out of control and disguised unemployment resulting from official policies on redundancies. The most important sector of the economy was in a state

of virtual collapse, and widespread government controls had generated distortions in costs and prices. The lingering unsettling effects of an attempted mercenary invasion in 1981 and an army mutiny in 1982 weigh heavily in the domestic environment.

2. Development policies and the allocation of resources

The Seychelles representatives explained that the Government's immediate policy objectives were to revitalize the tourist industry, to promote domestic exports, to redress the important financial imbalances being faced by the public sector, and to solve the growing unemployment problem. An immediate action plan had begun to be implemented in 1982 pending the introduction of the 1984-88 Development Plan, which would attempt to deal with the structural problems in a more orderly fashion.

a. Tourism

The Seychelles representatives felt that the main problem facing the tourist industry had been the lack of professionalism, particularly the low quality of management. At a time when tourist arrivals were growing at a rapid rate, the Seychelles tourist industry became characterized as unreliable. In an environment of rapidly expanding activity, a deterioration in services and facilities could be overlooked without major repercussions. However, when the world recession slowed tourist growth to a trickle, these factors became important liabilities. The Seychelles representatives acknowledged that the revaluation of the rupee in 1981 had aggravated the deteriorating situation to some degree by increasing local costs. The Government's wage and employment policies had not enabled the industry to offset costs. However, and most importantly, the tourist industry's difficulties could be traced to its unwillingness to restructure its operations and increase productivity to minimize costs. The initial slump in tourism generated excess capacity in access transport, and the airlines began reducing the number of flights, compounding the sector's problems. Earlier this year, two of the major international carriers serving Seychelles stopped services altogether.

The Seychelles authorities explained that they had taken a multi-faceted approach to revive the tourist sector. First, the Government had allowed a major European tour operator to take over two of the largest hotels in the islands and integrate them with a charter service. This operator had been able to restructure hotel costs, and, through the charter service, was able to keep a very high occupancy rate. On the basis of this operation about 20,000 tourist arrivals could be expected per year. Their tour prices to the Seychelles were some 20 to 30 per cent below the previously available tours and were competitive with most alternative tourist destinations. The Government itself has taken over some hotels, and in most cases the break-even occupancy rate had been lowered, sometimes by significant amounts, while at the same time

per room costs had been reduced. The Seychelles representatives were confident that, with these reforms, costs and prices in the Seychelles were competitive, and a growing number of visitors could be attracted. However, the most recent reduction of scheduled flights threatened the recovery of the tourist sector. Consequently, in October 1983, Air Seychelles would begin a weekly service, using wide-body aircraft, to Europe in conjunction with a major European airline in an effort to make up for some of the reduction in access transport. However, the Seychelles is bearing the financial risk of the operation by posting a guarantee prior to each flight. Various large European tour companies have requested seat allocations.

On the basis of the new developments in the tourist industry, the Seychelles authorities were expecting the number of tourist arrivals to recover from the low point of 48,000 reached in 1982 to somewhat under 60,000 in 1983. However, given the fact that there had been a major reduction in costs, they were expecting the per capita tourist expenditure to decline, leading to flat tourist earnings in 1983. Through May 1983 tourist arrivals were some 23,000, or 17 per cent higher than the similar period in 1982, and it was recognized that the level of arrivals would be governed to a large extent by the success of the new Air Seychelles operation.

b. Nontourist economy

In addition to a revival in the tourist industry, which was recognized as the key element in the recovery of the economy, the Seychelles representatives were aiming for an expansion of agricultural output. Success in the ongoing petroleum exploration could be an added dividend. Of primary importance in this regard was to increase the proportion of domestic production of foodstuffs. Although the agricultural potential of the Seychelles is limited due to the topography of the land, the quality of the soil, and inadequate water supply in some areas, improvements are possible. Progress in some areas has already been achieved. For example, pork and chicken production virtually met domestic demand. The Government is also encouraging the production of bananas, cassava, and other crops that could be used as staple foods to substitute for imported rice, with the objective of reducing rice imports by about 50 per cent in the next five years. Similarly, the Government aimed at reducing imports of animal feed by substituting local products such as breadfruit for cattle and pigs and residues from copra and fish for chicken.

The growth of the main agricultural exports (copra and cinnamon) has been hampered by low international prices and some disruptions in the sector's organization. Export sales are effected by the Seychelles Commodity Company (SEYCOM), which has been given a monopoly to guarantee that sale prices are adequate and that the full amount of the proceeds is repatriated. Producer prices for copra have been fixed above the export

price for some time. Beginning in 1982, the 10 per cent export taxes also ceased to be collected. Production has continued to fall, in part because the expansion of fruit and vegetable production has led to the cutting of coconut trees. Export prices for cinnamon have been rising, and, although producer prices were being set below export earnings to finance the subsidy on copra, farmers were being encouraged to increase the productivity of their plots. Earnings from cinnamon had been affected by the closure of the cinnamon oil distilleries and only cinnamon bark was being exported. However, a new distillery had recently been constructed and would begin operations in the second half of 1983. In addition, the Government was reconstructing one of the older distilleries and it was likely that in 1984 there would be a significant increase in earnings from cinnamon.

The Seychelles representatives said that the Government was anxious to exploit the fishing potential of the country. Joint fishing agreements had been signed with some foreign companies, and in 1982 the Government earned about SR 6 million from fishing licensing. During 1979-80, with the help of the French Government, several experimental fishing projects were conducted to determine the area's potential and appropriate technology. More recently, the Fishing Development Company (FIDECO) has been formed and it was operating 14 small boats, fishing largely for domestic consumption. The Seychelles representative indicated that the potential for tuna fishing in and around the Seychelles has already been tested; significant medium-term earnings could be expected from this activity. So far the authorities have moved slowly, as they needed technical assistance in drawing up the appropriate programs and contracts with foreign companies.

c. Employment, wages, and prices

The Seychelles representatives acknowledged that the downturn in the economy, particularly in the tourist industry, would have increased unemployment significantly had not government policy made it difficult for enterprises to declare redundancies. Many enterprises, particularly in the tourist industry, were considerably overmanned, given their present requirements. They explained that declaring employees redundant was not prohibited, but that the enterprises needed to show that the manning levels were the causes of their difficulties. In most cases enterprises were unable to demonstrate this to the satisfaction of the authorities.

The Seychelles representatives said that the large increase in wages that took place between 1978 and 1981 was made solely for social welfare objectives, largely without reference to workers' productivity. The basic assumption was that higher wages produce better morale and incentives to produce. However, the authorities now were of the belief that future increases in wages needed to be linked to productivity. Since 1981, there had only been minor cost-of-living adjustments.

In order to keep the unemployment level unchanged, the economy needed to create a thousand jobs per year. Some success in this area had been achieved previously, but the objective might not be reached in 1983. Current statistics on unemployment were not available, but at the present time the Employment Register had about 3.5 thousand persons seeking jobs, or a figure equivalent to about 19 per cent of formal employment. This figure had grown rapidly over the last two years, but the authorities felt it substantially overstated the level of actual unemployment, because the register included many people holding jobs who were merely seeking to improve their job type.

The Seychelles representative explained that the system of price controls dates back to August 1981. Since then some adjustments have been implemented to cover cases where permissible prices have proven to be inadequate to cover costs. Most imported items were controlled by means of maximum markups on landed costs, while most domestic products, mainly foodstuffs, were subject to fixed prices. However, prices could not be carefully policed due to manpower shortages. Unless prices were exorbitant, enforcement was lenient. The Seychelles representative felt that the best way of keeping prices at a reasonable level was through the provision of adequate supplies. Therefore, SEYCOM and its subsidiary companies played a crucial role in keeping prices down by guaranteeing the market a regular supply, which competed with the private sector. Although the present system had been helpful in keeping inflationary pressures down, the Seychelles representatives admitted that the delay in adjusting some prices had led to distortions. It was clear that some prices were out of line and needed revision. In this regard the Seychelles representatives pointed out that the data collected for the cost of living index reflected actual market prices.

2. Public sector finances and monetary policy

The Seychelles representatives explained that it was the Government's objective that the public enterprises should be made profitable as soon as possible. It was the authorities' objective not to let the parastatal system be a drain on public finances. With regard to some enterprises, the objective of making them profitable had to be weighed against some of the social functions they performed. The Seychelles representatives were emphatic that they would be closing those enterprises that fail to meet minimum standards, but at the same time they underlined that it was difficult to make undercapitalized enterprises function profitably very quickly. The Government was considering converting some of their transfers to equity, but even with such a change the enterprises would still be undercapitalized.

The Seychelles representatives expressed concern at the sizes of the financial imbalances recently generated by the public sector. In their opinion, they were temporary and reflected inexperienced management, who faced the difficult task of making undercapitalized enterprises

viable. The management problems extended into loose accounting and budgetary practices, but to an important extent these arose from a lack of accounting specialists. Inadequate pricing policies in the public sector and some overmanning, as discussed previously, also played an important role. However, a more careful review would indicate that the public enterprises had recorded progress in the few years in which they had been in operation. Most of them now had accounting procedures that were being implemented. In many cases, such as the Transport and Electricity Corporation, management was recording relatively good results, given the difficult environment in which they were operating.

Concern for the growth of public enterprise deficits led in November 1982 to the taking of steps to limit bank credit to public enterprises to the levels of agreed overdrafts. Public enterprises were advised that they were expected to take immediate steps to improve their position. To improve their earnings, the Government was going to review some of the regulated prices. In the first part of 1983, credit to public enterprises has fallen as expected. However, the Seychelles representatives recognized that at the same time the transfer of resources from the budget continued at a high level. Most of these resources were earmarked for specific purposes such as investments and were given only after the Government had reviewed the accounts of the enterprises.

The Seychelles representatives stated that, even taking into account the difficulties related to the public enterprises in the period 1979-82, budgetary operations did not absorb an unreasonable level of domestic financing. Only in 1981 was the Government's recourse to net bank credit large, and this expansion was corrected in 1982. Operations net of foreign resource flows and the expenditures they financed, but including net lending, averaged only 1.6 per cent of GDP during 1979-82 and 0.7 per cent if 1981 were excluded. The size of the overall deficit largely reflected development expenditures 1/ (including social and capital outlays) financed by grants and foreign concessionary loans. In addition, there had been a recurrent surplus used to finance capital outlays and net lending. However, the authorities were concerned that the surplus had been declining from 23 per cent of revenues in 1980 to 6 per cent in 1982. The 1983 budget as originally framed sought to reverse this trend through various revenue measures and an increased control of expenditure. Developments so far had not been favorable. Domestic revenues were now estimated to generate a major shortfall, falling even below the 1982 level. Although most revenue items were falling below expected levels, the shortfall was mainly accounted for by import duties and transfer of dividends and other resources from the public enterprises. The overall weakness in revenue reflected the contraction

1/ Capital expenditures are not integrated with the recurrent budget. They are based on a revolving five-year National Plan.

of economic activity, but the fall in import duty collections also resulted from the import restraints put into effect late in 1982. Moreover, the expected receipts from public enterprises had been overestimated, given the public enterprises' own difficulties and their limitation on bank borrowing. The fall in gross reserves of the Central Bank and, consequently, its interest earnings had also been an important factor.

The Government has been very careful to limit recurrent expenditures to budgeted levels. The growth in expenditures since 1979 reflected largely a major increase in outlays for social services and transfers. This item has risen from 35 per cent of total expenditures in 1979 to an estimated 50 per cent in 1983. The most rapid increase occurred with respect to education and was to some extent the result of the expansion of the National Youth Service and improved education facilities. Also, social security benefits had risen by a large margin, largely because of increases of benefit rates. Importantly, general administration, including expenditures on public order, had fallen as a proportion of expenditures from 40 per cent in 1979 to an estimated 26 per cent in 1983. The Seychelles representatives recognized that cash budgetary expenditures in 1983 were likely to be somewhat larger than budgeted, but this was the result of a big carry-over of 1982 expenditures into 1983 and not increased expenditures for the current year. In 1983 overall transfers to public corporations would likely be larger than in 1982, resulting from the increase in domestic financing now projected. Capital expenditure, however, would suffer a shortfall, mainly from the reduced availability of foreign resources. Consequently, as presently projected, the budget would have an overall deficit of about SR 127 million, requiring an important increase in the Government's recourse to domestic financing, equivalent to about 15 per cent of the initial stock of money. Through April the bulk of this financing need had already been taken up. However, as this had taken place in an environment in which credit to the public enterprises had been reduced slightly, the expansionary effect from the public sector had been equivalent to only 12 per cent of the initial money stock, or somewhat below that recorded in 1982. The Seychelles representatives expressed concern at developments so far in 1983 and at the projected outcome for the year as a whole, and considered this to be unsatisfactory. Consequently various revenue and expenditure measures were to be put into place in July, with the aim of reducing the deficit and its financing to a more manageable level. Given the high level of taxation, with revenues averaging 41 per cent of GDP between 1981 and 1983, it was difficult to raise additional revenue.

Since 1980 all new credit from the banking system has been oriented toward the public sector (Table 5), reflecting the rapid rise of this sector's activity. At the same time, credit to the private sector has fallen each year, reflecting the fall in general economic activity in the Seychelles and also the impact of the sale of some hotel properties, which resulted in the outstanding overdrafts of these hotels being repaid

to the banking system. The sluggishness of economic activity is also reflected in the trend of money and quasi-money, which has fallen from about 30 per cent of GDP in 1980 to 26 per cent in 1982. The banking system's net foreign assets have fallen from SR 164 million in 1980 to SR 82 million in 1982, in line with balance of payments developments.

Table 5. Seychelles: Summary Accounts of the Banking System, December 1979-March 1983

(12-month change as per cent of stock of money and quasi-money at the beginning of period)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>		<u>1983</u>
	Dec.	Dec.	Dec.	March	Dec.	March
Net foreign assets	11.3	28.3	-18.1	-11.5	-19.9	-16.6
Net domestic assets	10.5	0.9	17.6	11.2	11.4	7.5
Net credit to Govern- ment	5.2	2.4	9.6	2.4	0.4	7.0
Credit to public enterprises	--	4.6	7.6	10.0	12.4	5.9
Credit to private sector	9.8	2.1	-1.6	3.1	-4.0	-6.3
Other items (net)	-4.5	-8.2	2.0	-4.3	2.6	0.9
Money and quasi-money	21.8	29.2	-0.5	-0.3	-8.5	-9.1

Source: Data provided by the Seychelles representatives.

The Seychelles representatives explained that monetary policy has been largely accommodating until the end of 1982, when concern for the rapid growth of public sector credit led the monetary authorities to limit the overall expansion of credit to public enterprises to the outstanding level of agreed overdrafts. The reduction of credit to the private sector had not been the result of a policy initiative but reflected this sector's changing position. They felt that the reduction in money and quasi-money could be explained by the winding down of business activities by some firms, mainly in the tourist industry, as well as the difficulties faced by the economy.

The Seychelles representatives explained that six private banks were operating in the Seychelles and that there was considerable competition among them. This had resulted in some marked shift of deposits among them and on occasion had brought about liquidity problems for some of the banks. However, as most of them were tied to strong international partners, these transitory positions were quickly corrected. At the present time, given the Seychelles' very low inflationary rate, deposit rates were positive in real terms by a substantial margin. Time deposit rates ranged between 7.5 per cent and 11.8 per cent, while the savings deposit rates ranged from 6.5 to 8 per cent and the high real borrowing rate had become a burden for some businesses, particularly the public enterprises. Nevertheless, the authorities felt that, given the openness of the Seychelles economy, domestic interest rates should be competitive to encourage domestic financial investments, despite their negative impact on investments and businesses. The November 1982 credit measures had been successful in bringing about a reduction in credit to the public enterprises, but, with the unexpected shortfall in revenues, the pressure had now shifted to the Government. With the fiscal measures planned for the second half of 1983, the authorities were hopeful that the domestic credit expansion for 1983 would be kept below that of 1982. Also, there were indications that the decline in money supply was being reversed in 1983.

3. External policies

The Seychelles authorities said that the increase in the current account deficit of the balance of payments since 1980 was tied to developments in the tourist industry and the increase in long-term concessionary capital that had taken place during this period, which resulted in a rise in aid imports.

On the basis of developments through the first four months of 1983, it appears that in 1983 the balance of payments would record a further major deficit which could not be financeable, given the already low levels of official reserves. The exact amount of the reserve loss would depend on the level of short-term capital that would be available to finance imports during the year, which was difficult to gauge at this point, and the ability of the Central Bank to roll over some maturing short-term credits. These projections assume that tourist earnings would at least be equal to the 1982 level, despite an increase in tourist arrivals, due to lower per capita expenditure, an assumption which had proved correct in the first four months of the year. It also assumes a small further increase in the level of imports and a sum of capital and grants similar to the 1982 level. The Seychelles representative agreed that the size of the imbalance was untenable and that additional steps were necessary to bring it to a more reasonable position.

The Seychelles representatives felt that the low increase in domestic prices evident since the revaluation of the exchange rate in March 1981 had vindicated their position. Moreover, their demonstrated success in reducing costs in the tourist sector by improved management further supported their position that management practices had been more important in influencing overall cost than the exchange rate. Although some export commodities had faced some price disincentives, this should be reversed by the expected upturn in world market prices and the technical improvements being put in place, so that production could be stimulated at the current exchange rate. The Seychelles authorities are determined to utilize undisbursed grants and concessionary lines of credit available to them, and to abstain from using loans on commercial terms. This way the present favorable structure and terms of the external debt will be preserved and the burden of servicing it will be manageable.

The exchange and trade system of the Seychelles has been generally liberal. As part of the November 1982 measures, some tariffs were increased, and the extent of import licensing was increased. The Seychelles representatives said that originally the licensing system involved only a few products such as sugar and petroleum products. The objective had been to limit the number of importers to those that were efficient and had an ongoing business in these products. The measures introduced in November aimed at protecting new industries, as well as reducing import demand. The Seychelles representatives said that the licenses were not based on quotas but that decisions on providing licenses for imports were made on an ad hoc basis in relation to the need presented by the importer. Decisions as to whether to grant licenses are usually handed down one to three days after the application is received. Thus, in their view, the licensing system was being implemented in a liberal fashion.

IV. Staff Appraisal

The economy of the Seychelles has been suffering for some time from domestic financial disequilibria and balance of payments pressures. The extent of these problems has grown, largely as a result of an inadequate and delayed policy response. Much of the economy's margin of maneuver has been dissipated in the past two years, giving rise to the need for a firm response to the negative economic outlook.

It is clear that many of the economic difficulties, particularly in the tourist sector, have originated abroad, such as the impact of the world recession on world tourist demand and the rapid increase in long distance air fares which resulted from the second oil shock. However,

many competing tourist destinations have fared considerably better in absorbing these external shocks by following more appropriate domestic policies. The delay in dealing realistically with these problems has compounded their size. The negative developments in the tourist sector have influenced the overall economy in a substantial way. Therefore, a revival of the economy will require an upturn in this all-important sector of the Seychelles' economy.

The authorities' efforts to reduce costs in the tourist industry, as well as the new orientation that relies on charter services, appear to have been successful. These factors are expected to result in an upturn in tourist arrivals, although not necessarily in tourist income. Even after these measures are taken into account, there is evidence that costs in the Seychelles may still show a disadvantage when compared to the purchasing power of foreign exchange in other, competing destinations. Moreover, noncharter tourism has a significant cost disadvantage in the Seychelles at current costs. Following the cessation of services by two of the major air carriers to the Seychelles, it was obvious that a replacement of this transport was a necessary condition for a revival in tourist arrivals. However, the staff feels that the expansion of the service of Air Seychelles is a risky approach, as a result of the financial risks involved for a small country like the Seychelles to finance such an operation. These risks appear to be very large at the present time, given the expected continued weakness of the balance of payments and the low level of foreign reserves.

On the domestic front rapidly mounting overall public-sector deficits and the growth of distortions arising from prices that have been left unchanged over a long period have exacerbated the problems generated by a sluggish economy and have added pressures to the balance of payments. The rapid growth of parastatal organizations has led the public sector overall deficit to rise to 16 per cent of GDP in 1982 compared to less than 8 per cent in 1979. This level of overall deficit has also resulted in bank financing equivalent to about 15 per cent of the initial money stock. Although in 1983 the size of the overall deficit is likely to be reduced somewhat at an estimated 13 per cent of GDP, it still remains far above any appropriate level. There are many evidences of inefficiencies in the public sector that contribute to the overall deficits. Consequently, the present allocation of domestic resources needs to be looked at closely. The staff notes the efforts undertaken by the authorities to maintain nonparastatal expenditure at reasonable levels, so that it does not contribute to widening of the overall deficit in the public sector.

Improved financial management also requires improved procedures. There is a need to consolidate recurrent and capital expenditure into one budget and to fully incorporate the public enterprises into a public sector overview to determine their macroeconomic impact.

The policy of keeping a tight lid on wages since 1981 must be viewed as a welcome decision, which has offset, to some degree, the very high increases that were granted previously. Nevertheless, it appears to the mission that real wage levels remain high, given productivity in the economy and the impact wages have on overall costs.

The widespread price controls that have been in effect for some time have led to distortions in relative prices and have contributed to the precarious financial position faced by many of the public enterprises. In some cases, such as public transport, prices are now below the cost of the services. There are other examples which could be cited. Therefore, it is clear that a concerted effort to improve operation of the public enterprises will also require a review of prices in the economy and, most important, the establishment of a method that will allow more frequent reviews. The staff is heartened by the authorities' objective of attempting to make the public enterprises more efficient and their acknowledgement that major changes are needed in the price-setting mechanism.

The staff is aware that the exchange rate revaluation undertaken in March 1981 to a large degree only reversed a depreciation that had taken place in the real effective exchange rate of the Seychelles rupee in the previous 18 months. Moreover, since the exchange rate action was taken, price increases in the Seychelles have been far below those of its main trading partners, so that the real effective exchange rate has fallen somewhat since the revaluation took place. The staff feels that there is still a need to review the exchange rate further in light of cost developments in the tourist sector and in the Seychelles' major competing tourist destinations.

The balance of payments difficulties evident in the last few years are projected to worsen in 1983, with an estimated balance of payments deficit that could wipe out all of the reserves of the Central Bank and require some further foreign financing. Given this prospective scenario for 1983 and beyond, it is clear that substantive action is required from the authorities in the very near term.

Relations with the Fund 1/

Date of membership:	June 30, 1977
Quota:	SDR 2.0 million
Fund holdings of currency:	SDR 1.56 million (77.95 per cent of quota)
SDR position:	SDR 0.15 million, or 38.1 per cent of net cumulative allocation
Intervention currency:	Sterling
Rate:	Linked to the SDR at SDR 1 = SR 7.2345
Gold distribution and Trust Fund:	Seychelles was not a Fund member in 1974 and consequently has not participated in the distribution and has been ineligible for Trust Fund loans or profit distribution.
Technical assistance:	A member of the CBD panel is serving as adviser in the Research Department of the Central Bank of Seychelles, and a member of the FAD panel spent eight months in Seychelles between April and November 1982 serving as a Budget Advisor to the Department of Finance.
Recent staff contacts:	Article IV consultation discussions with Seychelles were held during the period of January 21 to February 5, 1982; the Staff Report (SM/82/65) and the accompanying background paper (SM/82/72) were discussed by the Executive Board on April 26, 1982. There is no Fund arrangement with Seychelles nor has there been any in the past.

1/ As of June 30, 1983.

IBRD Relations with Seychelles

Seychelles joined the IBRD in 1980 and has not so far received any loans. However, three projects have been proposed including transport and water sanitation, which would entail loans of around US\$9 million between fiscal years 1981 and 1982. In 1981 a country programs department mission visited Mahe and subsequently prepared a draft survey of economic developments. Another mission to Seychelles took place in June 1983 to review possible new loans.

SEYCHELLES - Basic Data

Area, population, and
GDP per capita

Area	443 square kilometers (100 islands)
Population: Total (1981)	65,000
Growth rate	0.9 per cent
GDP per capita (1981)	SDR 947.6

<u>National accounts</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u> Proj.
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(In millions of Seychelles rupees)

GDP at current market prices	803.6	951.5	948.8 <u>1/</u>	982.0 <u>1/</u>	1,016.4
Per cent change in period	34.8	18.4	-0.3	3.5	3.5

(Per cent annual increase)

<u>Consumer prices</u>	12.6	13.3	10.6	-0.9	-0.5
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(In millions of Seychelles rupees)

Estimated overall deficit of the
public sector

Public sector overall deficit	60.6	91.5	112.1	160.5	133.1
Budget (net)	38.3	28.9	13.7	62.8	53.1
Budgetary deficit	(60.6)	(62.4)	(87.3)	(112.3)	(126.9)
Minus transfers to public enterprises	(-22.3)	(-33.5)	(-73.6)	(-49.5)	(-73.8)
Total borrowing of public enterprises	22.3	62.6	98.4	97.7	80.0
Financing	60.6	91.5	112.1	160.5	133.1
Domestic (net)	10.0	15.8	62.5	40.2	59.2
Banking system	(9.8)	(15.8)	(50.6)	(44.6)	(59.2)
Other	(0.2)	(-)	(11.9)	(-4.4)	(-)
Foreign (net)	50.6	75.7	49.6	120.3	73.9

1/ Preliminary.

SEYCHELLES - Basic Data (continued)

<u>Government finance</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u> Prel.	<u>1983</u> Proj.
<u>(In millions of Seychelles rupees)</u>					
Revenue and grants	270.8	428.6	465.6	468.5	485.2
Revenue	219.3	340.2	391.5	415.0	400.1
Grants	51.5	88.4	74.1	53.5	85.1
Recurrent	19.5	29.0	25.0	21.0	33.9
Capital	(32.0)	(59.4)	(49.1)	(32.5)	(51.2)
Expenditure and net lending	331.4	491.0	552.9	580.8	602.1
Recurrent	205.7	261.7	332.4	391.1	438.0
Capital	125.2	227.3	152.3	159.8	109.8
Net lending	0.5	2.0	68.2	29.9	54.3
Recurrent surplus or deficit (-)	13.6	78.5	59.1	23.9	-37.9
Overall surplus or deficit (-)	-62.4	-62.4	-87.3	-112.3	-116.9
Total finance					
External	50.0	57.0	47.2	108.4	73.9
Domestic	10.0	5.4	40.1	3.9	43.0

(Changes as per cent of money stock at
beginning of period)

Money and credit

Average broad money	21.8	29.2	-0.5	-6.3
Domestic credit	10.5	0.9	17.6	11.4
Net claims on Government	5.2	2.4	9.6	2.4
Credit to private sector	9.8	2.1	-1.6	-7.5

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
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(In millions of SDRs)

Balance of payments

Exports	4.8	4.3	3.9	3.5	2.8
Imports	-64.9	-75.7	-78.9	-88.0	-95.1
Trade (net)	-60.1	-71.4	-75.0	-84.5	-92.3
Services	40.8	44.2	42.9	36.0	33.3
Current account	-19.3	-27.2	-32.1	-48.5	-59.0
Capital account	18.9	32.8	27.5	40.1)
Overall balance	-0.4	5.6	-4.6	-8.4) 59.0

SEYCHELLES - Basic Data (concluded)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>
<u>Gross official foreign reserves</u> (end of period)	12.1	20.3	18.0	10.3	...
In months of imports	2.2	3.2	2.7	1.4	...
<u>External public debt</u>					
Disbursed and outstanding (end of period)	...	19.06	28.9	45.5	...
Debt service as percentage of exports of goods and nonfactor services <u>1/</u>	...	0.6	0.8	2.0	...

1/ There have been no purchases by Seychelles under any Fund facilities.