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AFRICAN DEVELOPMENT BANK

SEYCHELLES
POLICY BASED PARTIAL CREDIT GUARANTEE (PBPCG) PROGRAMME

APPRAISAL REPORT

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November 2009

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Currency Equivalents

November 2009

UA 1	SDR 1.000
UA 1	US$ 1.5899
UA 1	EURO 1.0743
UA 1	SCR 19.6976

Fiscal Year

January 1st – December 31st

Weights and Measures

1 ton	=	2204 pounds (lbs)
1 kilogramme (kg)	=	2.200 lbs
1 meter (m)	=	3.28 feet (ft)
1 millimetre (mm)	=	0.03937 inch (“)
1 kilometre (km)	=	0.62 mile
1 hectare (ha)	=	2.47 acres

Acronyms and Abbreviations

ADB	African Development Bank
BoP	Balance of Payments
CIA	Counter Indemnity Agreement
DG	Deed of Guarantee
DPLs	Development Policy Loans
DSA	Debt Sustainability Assessment
GDP	Growth Domestic Product
EFF	Extended Fund Facility
EGRP	Economic Governance Reforms Programme
FDI	Foreign Direct Investment
FSA	Financial Services Authority
GBSL	General Budget Support Loan
GMA	Guarantee Maximum Amount
GoS	Government of Seychelles
IFI	International Financial Institution
IMF	International Monetary Fund
ISN	Interim Strategy Note
LSE	London Stock Exchange
MDGs	Millennium Development Goals
MIC	Middle Income Country
PBL	Policy Based Loan
PBPCG	Policy Based Partial Credit Guarantee
PER	Public Expenditure Review
PFM	Public Finance Management
RMC	Regional Member Country
RoS	Republic of Seychelles
SBA	Stand by Arrangement
SCR	Seychellois Rupee
SIDS	Small Island Developing State
SME	Small and Medium Enterprises
SNP	Seychelles National Party
SPPF	Seychelles People's Progressive Front
UK	United Kingdom
WB	World Bank

Policy Based Partial Credit Guarantee Information Sheet	
Description of the Instrument	The Policy Based Partial Credit Guarantee is an undertaking by the Bank to pay up to US$ 10m in interest payments of instruments tendered by the Government of Seychelles during the debt restructuring exercise that will take place in late 2009.
Instruments covered by the debt restructuring exercise	- US$ 230m of the Existing 2011 Eurobond Notes - EUR 54,750,000 of the Existing Amortising Notes - Two commercial loans for an amount of US$ 11m
Instruments offered in the debt exchange	- 16 Year **New Discount Bonds** with semi-annual step up coupon from 3% to 8%. Principal Amortization in 20 equal semi-annual amortizations. - 32 Years **New Par Bonds** with semi annual 2% interest until maturity. Principal Amortization: 7 equal semi annual amortizations.
Aggregate Guarantee Maximum Amount (GMA)	US$ 10m
Guarantee Termination Date	Up to 16 Years
Guarantee Call Dates	Semi-annual; matching the Interest Payment dates of the New Discount Bonds. The guarantee will be called in case of non-performance or default by the Seychellois authorities of any interest payment of the new exchanged instruments.
Rolling Guarantee	If the guarantee is not called it is “rolled over” to the next guarantee payment date until the guarantee agreement expires
Non Re-Instatable Guarantee	The guarantee is non re-instatable. If, at any point in time, the guarantee is called, the disbursed amount will be converted into a loan.
Loan Conditions	The loan start date for each disbursed amount will be the interest payment date upon default or when missed payment occurs. The loan has a maximum maturity of 20 years from the signature of the Guarantee Deed. A grace period of up to 5 years will be applied. Any call on the guarantee occurring after 15 years will result in a loan whose principal will be repaid in a single bullet payment at maturity. The terms and conditions will be similar to those applicable in a Policy based loan.

Programme overview

Context	Seychelles is now a very different place to what it was a year ago. Before 2009, recurrent expansionary fiscal and monetary policies, coupled with mismatched trade and exchange rate policies produced serious macroeconomic imbalances. This resulted, by the second half of 2008, in what Seychellois officials have described as "a point of no return". Indeed Seychelles' economy became so fragile that it defaulted on its foreign debt. In this context, the response of the Government of Seychelles (GoS) was two-fold. First, at the end of September 2008, it announced that it would restructure the country's external debt in a bid to clear accumulated arrears and place its debt on a sustainable path. Second, in October 2008 it launched a heavily frontloaded economic and financial reform programme, which has brought a notable turnaround to the country's macroeconomic environment. The Government's record in implementing the programme, albeit relatively short, is commendable and has received strong support from key development partners, notably the Bretton Woods Institutions. However, the public debt burden, and especially the debt to commercial creditors, remains a serious impediment to Seychelles' sustainable development. Following the Paris Club agreement in which bilateral creditors agreed to a 45% reduction of their overall nominal debt owed from the Seychelles, the GoS approached the Bank, in August 2009, requesting a US$ 10m Bank partial credit guarantee aimed at supporting efforts to obtain a comparable arrangement with commercial creditors. This partial credit guarantee will be applied to the interest payments of the new instruments offered by the Seychelles' to its commercial creditors.
Programme overview	The Policy Based Partial Credit Guarantee (PBPCG) programme aims to support the Government in maintaining its momentum in implementing the reform agenda. The programme's overarching goal is to support the Government's efforts to promote macroeconomic stability and sustainable growth, by reducing public debt to more sustainable levels. The programme's specific objectives are to facilitate commercial debt restructuring whilst reinforcing financial governance. This will help release resources to enable the GoS to pursue its development goals, as outlined in 'Seychelles Strategy 2017'.
Programme outcomes	Key public financial management (PFM) issues have already been earmarked in the Bank's Budget Support programme (approved in July 2009). Nonetheless, in line with the GoS's well sequenced reform programme, there is a need for additional focus on public debt management, in particular the commercial debt restructuring. The expected outcome of the PBPCG programme is that GoS reschedules its external commercial debt on terms comparable to the Paris Club agreement.
Needs assessment	The GoS is strongly committed to the reform agenda. However, the public debt burden, and especially the debt to commercial creditors, remains a serious impediment to Seychelles' sustainable development.
Bank's added value	The Bank's guarantee will improve the attractiveness of the exchange offer between Seychelles and existing bondholders by partially mitigating the risk profile of the restructured bonds. This will likely improve the level of participation of existing bondholders in the exchange offer and the terms (greater nominal value written off and lower coupons) for the Seychelles and, thus, it's debt profile going forward. A Bank guarantee may also be critical in ensuring that more than 75% of bondholders respond and agree to the conditions of the exchange offer. Crossing this threshold (75%) will allow the supermajority to modify the terms, under the collective action clause, of bonds held by any creditors who do not respond. This will, thus, ensure that all debt under the exchange offer is rescheduled.
Knowledge building	The Bank will capture the knowledge from this programme through continuous and regular monitoring, and the Programme Completion Report.

Table 1: Results based logical framework of PBPCG

Country Development Goals	PBPCG Objective	Outcomes		Outputs (including policy measures)	Assumptions/Risks and Mitigating Measures
		Baseline	**Target**		
Achieve public debt sustainability	**Strengthening public debt management**	Weaknesses in public debt management	Public debt management is improved	Medium Term Debt Management Strategy approved by end-2010 Annual borrowing plan for year t+1 approved by September year t	Risk: Debt insolvency by the country Mitigating measure: ADB will conduct regular discussions with the IMF regarding their monitoring of the debt rescheduling negotiations GoS is fully committed to the reform programme and resolving the debt issue Support from development partners – ADB and other donors (IMF, WB) involved in reform programme implementation
	Facilitate commercial debt restructuring	Limited and unfavourable access to international markets	Regain reasonable access to international financial markets	Sovereign rating improved upwards from D by end-2010	
		Paris club agreement (45% haircut) conditional on comparable treatment from commercial creditors	Fulfilment of Paris Club conditions	Successful debt restructuring with commercial creditors, comparable to Paris club agreement, by mid-2010	

I. INTRODUCTION

1.1 Seychelles is a Small Island Developing State (SIDS) with a population of 84,600 people (2006 official estimate). It is ranked as a Middle Income Country (MIC) and registered a per capita income of US$ 8,960 in 2008. **In spite of Seychelles' MIC status, it faces constraints typical of a small island state and Sub-Saharan Africa more generally**; including, single-sector dependence (tourism in this case), vulnerability to external shocks, poor market access, a high risk of environmental degradation and vulnerability to weather-related disasters.

1.2 Management proposes the following Report and Recommendation for a **Policy Based Partial Credit Guarantee (PBPCG)** to the Republic of Seychelles of US$ 10m (UA 6.4m). Following the Paris Club agreement in which bilateral creditors agreed to a 45% reduction of their overall nominal debt owed from the Seychelles, the Government of Seychelles (GoS) approached the Bank, in August 2009, requesting a Bank partial credit guarantee aimed at supporting efforts to obtain a comparable arrangement with commercial creditors. This partial credit guarantee will be applied to the interest payments of the new instruments offered by the Seychelles' to its commercial creditors.

1.3 **Seychelles is now a very different place to what it was a year ago.** Before 2009, recurrent expansionary fiscal and monetary policies, coupled with mismatched trade and exchange rate policies produced serious macroeconomic imbalances. This resulted, by the second half of 2008, in what Seychellois officials have described as "*a point of no return*". Indeed Seychelles' economy became so fragile that it defaulted on its foreign debt.[1] In this context, the response of GoS was two-fold. First, at the end of September 2008, it announced that it would restructure the country's external debt in a bid to clear accumulated arrears and place its debt on a sustainable path. Second, in October 2008 it launched a heavily frontloaded economic and financial reform programme, which has brought a notable turnaround to the country's macroeconomic environment. The Government's record in implementing the programme, albeit relatively short, is commendable[2] and has received strong support from key development partners, notably the Bretton Woods Institutions. Nonetheless, the Island's debt burden remains a serious impediment to its sustainable development.

1.4 **This proposed PBPCG operation is complementary to the Bank's budget support programme.** Seychelles requested a partial credit guarantee to support, in accordance with Paris Club conditions, its commercial debt restructuring (a critical measure to reduce public debt to sustainable levels). The Policy Based Partial Credit Guarantee (PBPCG) operation has been designed to complement the Bank's budget support loan (€ 15m) approved by the Board in July 2009 to finance the Economic Governance Reforms Programme (EGRP). The purpose of both the EGRP and PBPCG operations is to promote macroeconomic stability and sustainable growth, through, amongst others, improving financial governance and the reduction of public debt. A Bank guarantee will directly support debt restructuring and, as a consequence, help GoS improve fiscal sustainability (through a reduction of the debt servicing burden on the primary account) and its capacity to honour remaining debt obligations.

[1] Including a US$ 230 million public listed international bond.
[2] It was recently ranked third on the 2009 Ibrahim Index of African Governance.

II. RECENT DEVELOPMENTS

2.1. Political context

2.1.1. **Multiparty politics** were re-introduced in Seychelles in 1992 and elections have been held regularly since then. The most recent presidential elections, held in July 2006, were won with 54% of the vote by the incumbent president, representing the Seychelles People's Progressive Front (SPPF) . The opposition Seychelles National Party (SNP) got 46%. Legislative elections followed in May 2007, with broadly similar results. The SPPF has been in power for over three decades, but the electorate is almost evenly split between the two largest parties and a nationally encompassing political and economic agenda has been called for by both sides.

2.1.2. Moreover, both political parties recognize the **urgent need for reforms** and are broadly in agreement with the general thrusts of the reform programme. This augurs well for the reform efforts irrespective of which party is elected during the 2011 Presidential elections.

2.2. Economic developments

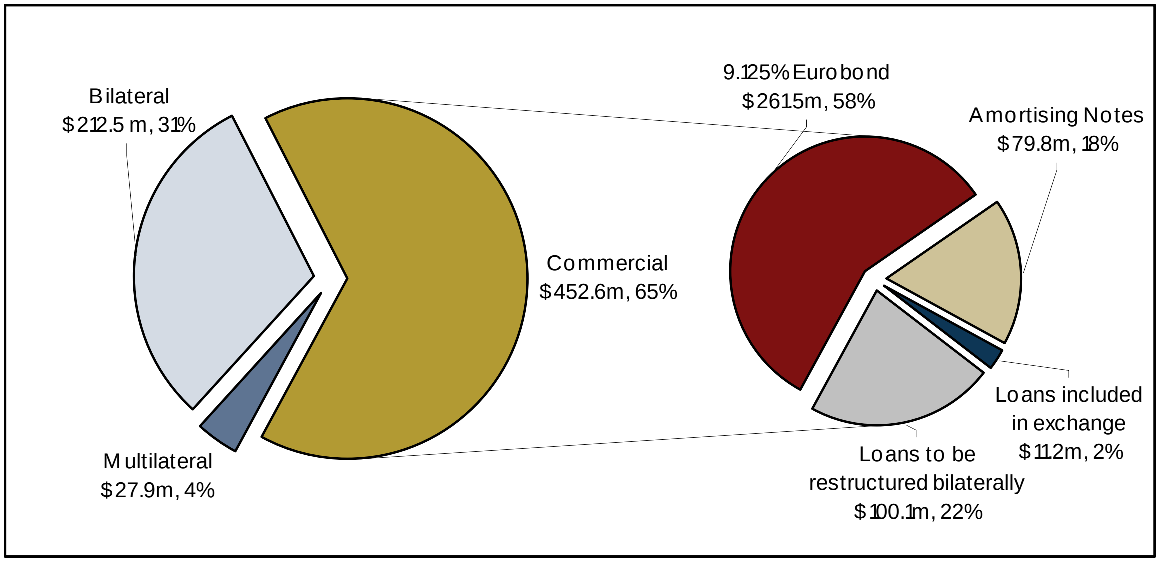
2.2.1. **Economic growth** was very low during the first half of the 2000s, but improved in 2005, driven by a construction boom and higher tourism arrivals. The recovery continued in 2006 and 2007, with real GDP growing by 5.4% and 7.3%, respectively. However, growth slowed down markedly in 2008 to 3.1%, due to external shocks, lower tourism earnings and the persistence of structural constraints – reflected in a rising debt burden and foreign exchange shortages.

2.2.2. Seychelles has pursued a controlled **exchange rate** regime since independence in spite of intermittent adjustments. Moreover, in recent years the Seychellois Rupee (SCR) was priced differently with respect to the US dollar and the EURO. This led to exchange rate misalignments and foreign exchange shortages. The Government adjusted the exchange rate in October 2006 and then again in October 2007 (when the exchange rate was set at SCR 8 to the dollar). In spite of these adjustments, a parallel market persisted, with a premium of about 30-40%. As part of its reform programme (see Section 2.3), Government radically changed its approach by floating the SCR on 1 November 2008. During the first week of trading, the rupee depreciated by about 56% against the dollar from SCR 8.9 to SCR 15.83. Since then the Rupee has appreciated and stabilised at about SCR 12.0 to the dollar (18 September 2009).

2.2.3. Government revenue averaged 46% of GDP per annum during 2001 to 2007, partly reflecting the high taxes typical of a welfare state. Still, public expenditure, as a percentage of GDP in recent years, has been consistently higher than revenue, and efforts to curb it have been largely futile. The overall fiscal balance on a cash basis (including grants) moved from a surplus of 1.7% of GDP in 2005 to a deficit of -6.2% in 2006, and stood at -9.7% in 2007. In 2008, although the **fiscal deficit** improved slightly, it remained negative at -3.7% of GDP and is estimated at -4.8% in 2009. These deficits, associated mainly with high spending in the social sector and net transfers to the parastatals (accounting for over 29% of total government expenditure and net lending in 2007), have been financed by external borrowing.

2.2.4. The **rapid growth of Seychelles' indebtedness** is a key domestic policy concern. The debt problem arose from Government's belief that it could sustain the welfare state and related expenditures on the basis of commercial loans. Measured in terms of GDP, the country's indebtedness has little parallel among developing countries, calculated at about 150% of GDP at the end of 2008. The growth of external debt from US$ 486m (47 % of GDP) in 2005 to US$ 693m at end-September 2009 (about 98% of GDP) has been a major contributor to total public debt. The bulk of external debt (65%) at end-September 2009 was due to commercial creditors (see Figure 1).

Figure 1: Seychelles external debt and breakdown of commercial debt – 30 September 2009



Source: ADB/IMF data base and Seychelles data, October 2009

2.2.5. In October 2008, facing near exhaustion of international reserves, the authorities announced that they would not be able to make a coupon payment on a US$ 230m Eurobond, also indicating that they would **approach creditors to seek an agreement on a comprehensive debt restructuring** (see Section 2.3). Standard and Poor's had already downgraded Seychelles to SD (selective default) and, following the October announcement, downgraded the Eurobond (9.125% due 2011) to "D" (default) and assigned a recovery rating of "4", indicating expectation of an average recovery of 30-50% on defaulted debt. Since then, no coupons have been paid.

2.3 Government reform priorities and debt restructuring strategy

2.3.1. These longstanding unsustainable macroeconomic policies, combined with external shocks, culminated in mid-2008 with the near exhaustion of foreign reserves and missed payments on public debt obligations. As a result, **GoS embarked, in October 2008, on a comprehensive frontloaded reform programme, supported by a two year IMF Stand by Arrangement (SBA)**, to address the dire situation. The reform programme has four main thrusts: (i) achieving full convertibility of the Seychelles Rupee (SCR) and introducing a market-determined floating exchange rate; (ii) adopting a comprehensive debt restructuring strategy; (iii) reducing the role of the State in economic activity, through a public sector reform programme and promoting private sector development; and (iv) reinforcing Public Finance Management (PFM) reforms and strengthening economic and financial governance.

2.3.2. **The reform programme continues to be successfully implemented.** Both the second and third review of the IMF's SBA (June and November 2009 respectively) concluded that the programme is firmly on-track and macroeconomic stabilisation has advanced rapidly, as a result of the liberalisation of the exchange rate regime, strong fiscal adjustment and prudent monetary policies. Inflation has been almost nil since March 2009 and the exchange rate has appreciated steadily in early 2009. Government revenue has been more buoyant and the primary surplus is well above the SBA target, allowing a large repayment of domestic public debt. In addition, gross official reserves had risen considerably by June to about 1 month of imports; also above the SBA target. The November SBA review concluded that the economy is responding well to the Government's ongoing reform agenda, with the contraction in economic activity expected to be somewhat less than previously forecast (real GDP is now expected to decline by 7.5% in 2009 as opposed to earlier projections of 9.6%). Economic recovery is expected to strengthen, with growth rising to 4%, in 2010. These achievements show the strong resolve and determination of GoS to rebalance the economy and put the country on a more sustainable development path.

2.3.3. Going forward, the Government has the firm intention to continue consolidating the satisfactory macroeconomic results by maintaining a tight fiscal policy, and progressively putting in place supporting structural reforms to remove constraints to growth and improve the performance of the public sector. Progress in reducing inflation, in conjunction with the appreciation of the Rupee, has allowed for a gradual easing of monetary policy. The preparation of a fundamental reform of the tax system is underway and aims to harmonise rates, broaden the tax base, and raise self-compliance, while maintaining the overall tax-take. The preparation of a major reinforcement of control over parastatal performance, as well as further privatisation of a number of state-owned companies, and a strengthening of the financial system are also ongoing.

2.3.4. **The reform programme supported by the *IMF* was** the **first step** in helping the country put its debt level on a sustainable path and, also to facilitate negotiations with multilateral and bilateral creditors. Following agreement with the IMF, the **next step** was to attract support from *multilateral creditors*. In April 2009, the Bank's Interim Strategy Note (ISN) was approved by the Board for 2009 to 2010. Under this strategy, a gradual approach to reengagement was proposed; with the Bank providing financial support to the Government's fast evolving economic stabilisation and debt reduction programmes. In this respect, a budget support loan of € 15 m was approved by the ADB Board in July 2009 to finance the Economic Governance Reforms Programme (EGRP). This will be disbursed in two equal tranches of € 7.5 m; the first was disbursed in November 2009 and the second is expected in 2010. At the same time, the *World Bank* has been reengaging with the Seychelles. In terms of financial support, the World Bank approved on 6th November a first Development Policy Loan (DPL) of US$ 9 m, and a second one of the same amount is planned for 2010. The *European Commission* is also planning a € 15.5 m Budget Support programme over a three-year period, which is expected to be approved in the last quarter of 2009. The plan is to disburse between € 6 m and € 8 m by end-2009/early-2010.

2.3.5. Following support from multilateral creditors, **the Seychelles approached the *Paris Club* for a reduction in its bilateral debt. On 16 April 2009**, the Paris Club agreed on an overall nominal debt cancellation of 45% of approximately US$ 140m owed by Seychelles to eight countries within the Paris Club. The agreement will be implemented in two phases: (i) 22.5% of the debt stock, has already been cancelled on 1 July 2009; (ii) the remainder will be cancelled on 1 July 2010 conditional upon - (a) timely debt service to the Paris Club, (b) compliance with IMF conditionality, and (c) comparable treatment being extended to other external creditors in net present value terms. The remaining debt after cancellation will be repaid on an amortising basis, after a grace period of five years.

2.3.6. **Seychelles is currently implementing a debt restructuring strategy for external commercial creditors,** with the support of international financial and legal advisors. As illustrated in Figure 1, Seychelles currently has US$ 452.6m of outstanding external debt to commercial creditors. Following the extensive consultations that have taken place over the last year between the GoS and commercial creditors, two steps are being undertaken to restructure this debt: (i) the holders of the Eurobond, amortising notes and two of the existing loans – totaling US$ 352.5 m – will be invited to participate in a public exchange offer for new bonds, and (ii) creditors holding the other 11 of the 13 loans (totaling US$ 100.1 m) will be asked to restructure their loan agreements with the Government to effect an extension of maturities, lowering of coupons, and, possibly, a reduction of principal. The Government is committed to the principles of transparency and inter-creditor equity and will therefore only agree to issue new bonds or modify commercial bank loans on terms that are comparable to those agreed by the Paris Club in April 2009. **Restructuring commercial debt is critical as it forms the bulk of external debt**, is necessary for the Paris Club agreement to take effect and, as shown later in Figure 2, is essential for Seychelles to reach long-term debt sustainability.

2.3.7. As shown in Box 1 GoS has proposed two instruments for the public exchange offer.

Box 1: Indicative Terms of the Proposed Exchange Instruments

1. New Par Bonds

Issuance Date:	30 December 2009
Face value reduction:	None (but NPV is 50% of the Initial Face value)
Maturity:	32 years
Interest:	Semi-annual: 2% until maturity
Principal Amortization:	7 equal semi-annual amortizations, starting in June 2038

2. New Discount Bonds

Issuance Date:	30 December 2009
Face value reduction:	50%
Maturity:	16 years
Coupon:	Semi-annual and Step Up; 3% for 2 years; 5% for 3 years; 7% for 3 years; 8% until maturity
Principal Amortization	20 equal semi-annual amortizations starting in June 2016

2.3.8. In addition, Seychelles has stated that they will only issue New Par Bonds if the principal amount of New Par Bonds to be exchanged for the existing instruments is at least US$ 50m. If it is less than US$ 50m, holders of instruments that have participated in the exchange will be subject to the conditions applicable to New Discount Bonds as set out in the Exchange Offer Materials.

2.3.9. It is important to note that the bonds affected by the debt restructuring contain collective action clauses. These collective action clauses permit an amendment to the payment terms of the relevant bonds if holders representing at least 75% of the aggregate principal amount agree, through the passing of a resolution, to the amendment. Thus, if the 75% threshold is passed, the amendment will take effect for **all** holders. The GoS debt restructuring strategy therefore places great emphasis on achieving this threshold.

2.3.10. The principal amount of new discount bonds and new par bonds to be exchanged for the existing bonds is shown in Table 2.

Table 2: Principal amount of New Discount Bonds and New Par Bonds

Existing Bonds	New Par Bonds	New Discount Bonds
For each US$ 1,000 principal amount of 2011 Notes tendered.	US$ 1,000	US$ 500
For each € 1,000 principal amount of Amortising Notes tendered.*	US$ 1,414.30	US$ 707.15
For each US$ 1,000 principal amount of US$ denominated existing loans tendered.	US$ 1,000	US$ 500

* The exchange rate applied is €/US$ = 0.7070636/1

2.4 Social impacts of reform programme

2.4.1. **Human development** has been an essential element of all policies and national development plans since independence. As a result, Seychelles has already met the target for most of the eight Millennium Development Goals (MDGs), which has led to a Human Development Index (HDI) of 0.842 (United Nation's 2007/08 rankings), placing Seychelles highest in Africa, 50th in the world, and comparable to many OECD countries. In terms of GDP per capita, at about US$8,960 in 2008, the country ranked second highest in Africa. Other key indicators such as life expectancy, adult literacy rate, population growth rate, and gender equality compare favourably with achievements in developed countries. Such remarkable results on the social front are due to the country's comprehensive welfare system, which was largely financed through budget deficits. This system has recently, however, been questioned in terms of its sustainability regarding the country's current severe debt problems.

2.4.2. Given the substantial reforms at the end of 2008 (which have led to a contraction of the economy in the short to medium-term[3]), combined with the global economic slowdown and the change in Government approach from a universal to a targeted welfare system **there is concern that poverty and vulnerability may be on the increase** (around 18% of households are currently estimated to be living below the food poverty line). In order to counter this, the Government has recently established a Welfare Agency, supported by the World Bank, to better target Government expenditure to those most in need. So far, the initial requests for welfare assistance have been limited; however, should the demands for welfare assistance rise, significant resources have already been earmarked as part of the IMF programme,.

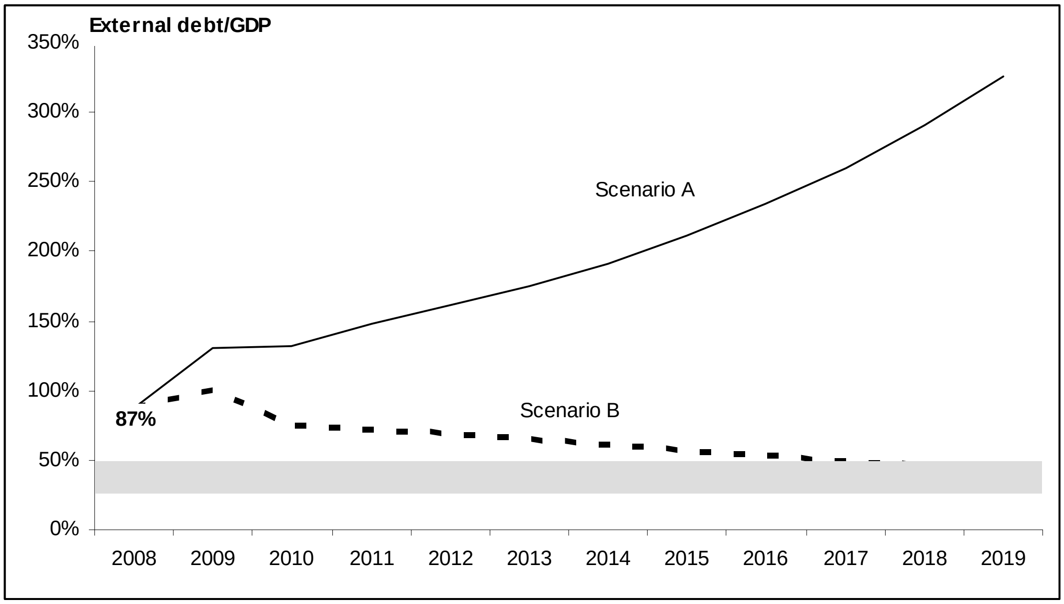
2.5 Main constraints and challenges

2.5.1. **Public debt will remain unsustainable unless a comprehensive debt restructuring agreement is reached with commercial creditors.** The IMF's most recent Debt Sustainability Assessment (DSA), July 2009, confirms that Seychelles' public debt remains unsustainable even after the restructuring of Paris Club debt in April 2009. The highly concessional Paris Club agreement was an important step toward achieving sustainability. However, Seychelles' debt burden remains an impediment to its growth efforts and comprehensive debt restructuring with commercial creditors, involving substantial reduction in both debt servicing and amortization, is required, in order to decisively restore long-term sustainability. This is shown quite clearly by the two Balance of Payments (BoP) scenarios presented in Annex 6 and depicted in Figure 2. Scenario A shows the impact on Seychelles' BoP assuming only Paris Club restructuring. Scenario B shows the impact on Seychelles' BoP assuming both Paris Club restructuring and comparable treatment for other creditors. In Scenario A, external debt as a percentage of GDP rises from 87% in 2008 to over 320% in 2019 – an extremely unsustainable position[4]. Only through comprehensive debt restructuring with commercial creditors will the situation become more sustainable. In Scenario B, external debt as a percentage of GDP falls from 87% in 2008 to about 40% in 2019.

[3] Real wages have been eroded by high inflation (resulting from the devaluation) and unemployment is rising due to the slowdown in output and the downsizing of the public sector through the Voluntary Departure Scheme (VDS).

[4] The IMF has indicated that in assessing whether external public debt is sustainable there are no specific targets for debt to GDP (or reserves or exports) for middle income countries (MICs) like Seychelles. IMF research has shown that for MICs **a range of 30% to 50% of GDP seems reasonable**, and that for countries that have defaulted it tends to be closer to 30%.

Figure 2: Seychelles debt sustainability scenarios



Source: IMF Second Review under the SBA, July 2009

2.5.2. **Commitment to see the reform programme through.** Seychelles has embarked on a front-loaded reform programme (see Annex 1and 7) during a downturn in the global economy; this is putting significant strain on the economy. For example: (i) consumers' purchasing power has declined; (ii) tourism receipts are 17% lower so far in 2009, compared to the same period in 2008, due to the global recession in Europe – Seychelles' main tourism market; (iii) targeted welfare is to replace the long-standing universal system; (iv) the public sector is to be further downsized (1,800 people have already been laid off) in order to make way for a private sector driven growth strategy; and (v) overall the IMF has projected that growth will decline by 7.5% in 2009.

2.5.3. **Enhance the private sector's ability to drive the economy.** Over the past 30 years, Government has been the key driver of the economy. One of the core pillars of the reform programme is to reduce and adjust Government's role to that of facilitator. A number of challenges, however, need to be resolved for the private sector to flourish and play a dominant role in the economy. The investment climate regulatory framework is not conducive to a competitive and fair business environment. After all the years of a socialist system, including extensive subsidies and universal welfare provision, it will take some time to adjust the entrenched culture of dependence on the State and create an entrepreneurial spirit. Moreover, access to finance is generally difficult and there are numerous infrastructure bottlenecks (e.g. port upgrading/modernisation) that need to be addressed.

2.5.4. **Inherent vulnerabilities of a Small Island Developing State (SIDS).** These include a small land area, limited natural resources and environmental vulnerability. Given the limited opportunities for economic diversification, the main engines of growth, tourism and fisheries, are inextricably linked to the quality of the natural and physical environment. In addition, like other small islands, Seychelles faces the problem of manpower shortages emanating from its very small population base. This results in the recruitment of expatriate labour as a temporary measure. The Government needs to optimize the utilization of available knowledge and skills, while ensuring that contracts of non-Seychellois workers include training for locals to build capacity.

III. RATIONALE FOR THE PROPOSED PROGRAMME

3.1. Link with National Development Plan and Interim Strategy Note

3.1.1. **The Policy Based Partial Credit Guarantee (PBPCG) programme is aligned with the Bank's Interim Strategy Note (ISN) 2009-2010, which in turn is consistent with the Government's development programme 'Seychelles Strategy 2017'.** The thrusts of Strategy 2017 are promotion of sound macroeconomic management, competitiveness and good governance, equity and sustainability. The expected outcomes of the Strategy are presented in Annex 8. The guarantee programme is also consistent with the Government's frontloaded reform programme (see Section 2.3), which includes as one key objective the adoption of a comprehensive debt restructuring strategy.

3.1.2. **The Bank's ISN comprises one pillar**, namely '**support the reform programme to achieve sustainable growth'**, with the lending programme focused on the provision of a budget support operation, and non-lending operations focused on technical assistance and country analytical work, including a joint Public Expenditure Review (PER) with the World Bank.

3.2. Main analytical works underpinning

3.2.1. The design of the guarantee programme has been guided by the Bank's 2009-2010 Seychelles Interim Strategy Note (April, 2009), the recently approved Bank EGRP budget support operation (July, 2009), the IMF Article IV Consultation and Request for a Stand-By Arrangement Staff Report (December, 2008), the Second Review under the Stand-By Arrangement (July, 2009) and the IMF Debt Sustainability Analysis (March, 2009).

3.2.2. Important conclusions from these upstream studies are that: (i) macroeconomic challenges relating to the ongoing country's debt burden are significant; (ii) government commitment to economic reforms has remained resilient since mid-2008; and (iii) comprehensive public debt restructuring, involving a substantial reduction in the overall debt burden, is critical for putting public debt back on a sustainable path.

3.2.3. In addition to the Bank's own assessment, the guarantee programme design benefited from intensive consultations with country stakeholders including government officials, donors (notably the IMF, World Bank and the EC), as well as Seychelles' financial and legal advisors.

3.3. Lessons from past and on-going similar or quasi-similar operations

3.3.1. This is the first time that a DFI will offer a partial credit guarantee under the framework of debt re-structuring. Sovereign partial credit guarantees have been offered by sister institutions in the past to facilitate the access of countries to capital markets. **In spite of the uniqueness of this operation**, some lessons can be drawn from these sister institutions. Private sector guarantees, as well as policy-based operations in Seychelles and across Africa have also been used to enrich the proposal.

3.3.2. The World Bank provided a rolling re-instatable policy based guarantee for Argentina on a series of zero coupon bonds in 1999 and one for a Colombia bond issue in 2001. The main objective of these guarantees was to help the beneficiary countries to mobilize new resources after a protracted period of not being able to access international capital markets. In the case of Argentina, the guarantee was first called in 2002. Following this, Argentina did not repay the World Bank within the 60 days cure period that would have allowed the guarantee to be reinstated and rolled over to the next zero coupon series. As per the agreement, the World Bank extended the terms for reimbursement to a loan of four and half years with a three year grace period. The bond holders were not completely clear on this arrangement between the World Bank and Argentina (even though it was disclosed in the prospectus). They had expected the World Bank to exert sufficient pressure on Argentina to cure the outstanding payment within the 60 day period. Therefore, the outcome of this guarantee operation was perceived badly by both bond holders and the market. **The main lessons learned[5] are the need to be clear on the scope of the guarantee and to avoid sending the wrong signal to creditors.** Also, key elements like the economic and financial situation of the country, as well as the relationship between the country and donors – especially regarding the debt management strategy, growth prospects and reform implementation – require thorough assessment (as per ADB's general and technical preconditions for a partial guarantee as detailed in Annex 7) .

3.3.3. The Bank's experience in providing guarantee facilities has been concentrated in private sector operations[6]. The main purpose of these guarantees was to provide partial guarantees of small loans provided by institutions to SMEs. Although these experiences are still relatively recent, **these kinds of operations have been successful** (no guarantees have been called to date) and **translated into a higher leverage ratio.**

3.3.4. Across Africa, the major lessons coming from Policy Based Loans (PBL) are articulated around the identification of appropriate reforms, the timeframe of implementation and appropriate capacity building. For example, an important recommendation is to complement the PBL operation with institutional support in order to strengthen capacity at the level of the country/responsible ministry. A PBL is also a key instrument in donor coordination and reinforces dialogue between donors and the country. **As a result, this proposal will ensure coordination and complementarity with the Bank's current budget support operation.**

3.4. Collaboration and coordination with other donors

3.4.1. **Donors have expressed significant support for the Bank's proposed guarantee programme.** Given Seychelles' remarkable performance in implementing their reform agenda (strong fiscal and monetary discipline, and firm government ownership), the IMF will continue to support Seychelles' medium-term structural reform programme through a recently (November 2009) negotiated three-year successor arrangement under the Extended Fund Facility (EFF). The IMF has highlighted that successful commercial debt restructuring is a *key precursor* to the medium-term programme in order to secure a sustainable fiscal and macroeconomic future for the Seychelles. As a result, the Bank's guarantee programme will complement what the IMF and other donors are doing, given that it would have significant leverage in helping the country succeed in its commercial debt rescheduling, which is part of the broader debt reduction strategy supported by the IMF and other donors. Furthermore, the IMF has noted that a Bank guarantee would fit within the non-concessional borrowing limit, defined under SBA programme.

3.4.2. In late October, following discussions between Seychelles' transaction advisers and the World Bank, **the GoS requested a policy-based guarantee from the World Bank to provide further assistance to the commercial debt restructuring**. Although the timeframe is such that it will be challenging for this request to receive World Bank Board approval before the public exchange offer launch date, planned for mid-December, the World Bank is nevertheless exploring how to respond positively to the GoS request in a manner and timeframe that can also add value to

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[5] Refer to Annex 7 of the Bank Policy on Guarantees (ADB/BD/WP/2003/85)

[6] Ghana: proposal for an export oriented SME guarantee programme of USD 24 million; Republic of Tanzania: proposal for partial credit guarantee facility of USD 8 million; Algeria: proposal for the award of a partial guarantee of € 6m to Maghreb leasing; South Africa: MTN partial credit guarantee for project finance; Cameroon: MTN partial credit guarantee for project finance and South Africa: DBSA guarantee.

the restructuring. The concept note for World Bank participation is due to be discussed by their Operations Committee in early December.

3.5. Bank's comparative advantages and added value

3.5.1. The Bank's guarantee will improve the attractiveness of the exchange offer between Seychelles and existing bondholders by partially mitigating the risk profile of the restructured bonds. This will likely improve the level of participation of existing bondholders in the exchange offer and the terms (greater nominal value written off and lower coupons) for the Seychelles and, thus, it's debt profile going forward. Ultimately, the authorities hope that it will be easier to place the restructured issue with a Bank guarantee, as bondholders view multilateral involvement as a demonstration of support by the international community for the Government's reform programme.

3.5.2. A Bank guarantee may also be critical in ensuring that more than 75% of bondholders respond and agree to the conditions of the exchange offer. Crossing this threshold (75%) will allow the supermajority to modify the terms, under the collective action clause, of bonds held by any creditors who do not respond. This will, thus, ensure that all debt under the exchange offer is rescheduled and, secondly, dramatically reduce the risk of expensive lawsuits against Seychelles from holdouts acting against the interest of the majority.

3.5.3. Finally, Section 5.2 provides a financial analysis of the monetary value of the Bank's partial guarantee.

3.6. Application of Bank Group partial guarantee policy and good practice principles on conditionality

3.6.1. The programme will follow principles and modalities to guide the use of Bank guarantees as indicated in the "Guiding principles for Bank Guarantees (2000)" and in the "Bank Policy on Guarantees (2004)".

- **Eligible country should have demonstrated a strong track record of performance**. Referring to the conclusion of the IMF mission in October 2009 "strong progress is being made by the Seychelles authorities in their reform programme. The reform programme is front-loaded and is on track and is achieving its economic stabilization and reform objectives". Moreover, macroeconomic indicators have improved and good progress is being made with the overall debt restructuring strategy.

Due to the specific nature of the programme, the policy based guarantee will apply good practice principles on conditionality as requested in the PBL generic framework:

- **Reinforce ownership:** The reform programme is fully owned by Seychelles and is built around Seychelles Strategy 2017, prepared by the Government through broad-based consultations with stakeholders. The Government is committed to the successful negotiation of the commercial debt burden and has already hired international advisors to handle this.
- **Agree on a coordinated framework:** The main development partners agreed on a series of parallel and synergistic interventions in support to the Government's reform programme. Even if the donors are not directly involved in the guarantee operation, the policies supported by the programme are directly linked to the IMF SBA.
- **Customize the accountability framework and modalities of Bank's support to country circumstances:** The Bank's support reflects the Government's expressed intentions and is appropriate for a country that is heavily in debt, especially in terms of commercial debt.

- **Application of Bank Group policy on non-concessional borrowing:** Seychelles is a MIC (category C country) which can only access the Bank's non-concessional resources. The guarantee amount requested falls in the country lending limit available for Seychelles.

3.7. Country readiness assessment and compliance with Bank Group safeguards policy

3.7.1. Since Board approval of the budget support, in July 2009, the country has shown remarkable progress in both implementing reforms and through improved macroeconomic indicators. Therefore, Seychelles meets the Bank's prerequisite conditions (general and technical) for a Partial Guarantee as comprehensively detailed in Annex 7.

IV. PROPOSED PROGRAMME

4.1. Programme goal and objectives

4.1.1. This programme aims to support the Government maintain its momentum in implementing the reform agenda, as defined in the Government's Letter of Development Policy (see Annex 1). Thus, the programme's **overarching goal** is **to support the Government's efforts to promote macroeconomic stability and sustainable growth, by reducing public debt to more sustainable levels**. The PBPCG programme is based on the Operations Policy Matrix (see Annex 2), which was agreed between the GoS and the Bank during the appraisal mission in November 2009.

4.1.2. The programme's **specific objectives** are **to facilitate commercial debt restructuring whilst reinforcing financial governance**. This will help release resources to enable the GoS to pursue its development goals, as outlined in 'Seychelles Strategy 2017'.

4.1.3. The programme objectives will be achieved by supporting current reforms. Indeed, the Bank's proposed support in the targeted areas of debt management and financial governance will complement and strengthen coordinated actions that are already being carried out by the Bank (under its budget support operation), the IMF (under the SBA) and the World Bank (under its forthcoming budget support operation).

4.2. Programme components and expected results

4.2.1. As indicated previously, one objective of the GoS's reform programme is to put the country's debt profile on a sustainable path. In order to achieve this, GoS is taking a number of steps, including: strengthening public finance management (PFM), improving public debt management and consolidating public finances by reinforcing fiscal revenue and tightening expenditure. These measures will help reduce the debt burden and rebuild investor confidence in the country. The proposed PBPCG programme will reinforce support to the GoS in implementing these steps by focussing on strengthening public debt management.

Strengthen Public Debt Management

4.2.2. Focussing on this element will enable the Bank to reinforce its dialogue with Government on strategic issues relating to financial governance. Indeed, key public financial management (PFM) issues have already been earmarked in the Bank's EGRP. Nonetheless, in line with the GoS's well sequenced reform programme, there is a need for additional focus on public debt management, in particular the commercial debt restructuring.

4.2.3. As mentioned earlier, the Government has already succeeded in obtaining debt relief from the Paris Club and has also enacted a new Public Debt law in late 2008. Further, the Government is finalizing a medium-term debt management strategy and annual borrowing plans (as from the 2010 budget). These are two prior conditions for the disbursement of the second tranche of the EGRP in 2010.[7]

4.2.4. In spite of this progress in debt management and re-profiling, the bulk of external debt remains with commercial creditors. Hence, as the next critical step in debt re-profiling, the Government needs to reach a mutually satisfactory agreement with external commercial creditors on favourable debt relief terms.

4.2.5. The PBPCG programme will support these endeavours to ensure an improved sovereign rating and successful debt restructuring with commercial creditors by end-first quarter 2010. This will also intrinsically complement measures outlined in the Bank's budget support programme to improve public debt management.

Benchmark (*to measure progress*): Commercial creditor debt restructured ***Required evidence***: Official notification letter from GoS indicating successful commercial debt restructuring

4.3 Complementarity with ongoing Bank Budget Support Operation

4.3.1 As already noted, the PBPCG programme will fully complement the Bank's budget support operation, approved in July 2009, to finance the Economic Governance Reforms Programme (EGRP). The overarching goal of the PBPCG programme is the same as that of the EGRP. Both the budget support operation and the guarantee programme would be in line with the sequenced actions taken by Seychelles to remedy its debt crisis. The specific objective of this programme, however, is to facilitate commercial debt restructuring.

V. FINANCIAL INSTRUMENT

5.1 Description of the Instrument

5.1.1 The Policy Based Partial Credit Guarantee is an undertaking by the Bank to pay up to US$ 10m in interest payments of the New Discount Bonds that will be offered to investors during the Seychelles exchange offer.

5.1.2 This instrument is a 16 year rolling non re-instatable guarantee. A rolling guarantee is such that if a guarantee is not called it is "rolled over" to the next guarantee payment date until the guarantee agreement expires. Therefore, if the Trustee does not call on the guarantee to pay the interest due on any given interest payment date, the guarantee will be passed on to the following date. This will occur for as long as no disbursement occurs and until the Guarantee Termination date (16 years). If, at any point in time, a disbursement is made on a portion of the guarantee amount, at the next interest payment date, only the unpaid guarantee amount (referred to as the relevant amount) can be called. This process will be repeated for as long as any portion of the guarantee maximum amount remains unspent. For simplification, refer to the Scenario Examples in Box 2.

[7] Economic Governance Reforms Programme (EGRP) approved in July 2009 - (ADB/BD/WP/2009/117)

Box 2: Scenario Examples for the Rolling Guarantee

All the scenario examples below assume a total amount eligible for debt discounts of US$ 271m and a face value haircut of 50%. The principal amount on the bonds eligible for guarantee will be US$ 135.5m. The interest payment due at various interest payment dates is detailed in Annex 9.

Scenario 1: The Guarantee is never called
If the Guarantee is never called, the US$ 10m guarantee amount will be rolled over from one interest payment date to another until the guarantee termination date occurs , ie after 16 years

Scenario 2: The Guarantee is called at the 4th interest payment date
In this scenario the Bank will pay the interest amount due on that date (US$ 2m). The unpaid US$ 8m of guarantee will be passed on to the next date. If there is a default again on period 5, the US$ 3.4m of due interest will be paid by the Bank. The relevant guarantee amount will be US$ 4.6m. This amount will be rolled on to the next interest payment date. This process will be repeated until all the relevant guarantee amount is spent.

5.1.3 In a non re-instatable guarantee, once a portion (or the full) guarantee amount is called, this portion (or the full) guarantee amount may not be rolled over, even in the event of re-payment by the GOS. Under the provisions of this PBPCG, once the guarantee is called, the amount that is called will be automatically converted into a Loan. The terms and conditions of this Loan are described in section 5.1.7.

5.1.4 The Disbursement Procedures of the Guarantee are as follows:

At any time before the termination of the guarantee, the principal paying agent shall as soon as practicable notify GoS and the Bank as to whether or not any payment has been received by the specified date and time. If an interest payment default has occurred on an Interest Payment Date in respect of the New Discount Bonds and has continued for at least five (5) days, then the Trustee:

- shall promptly notify the Bank by facsimile and telephone of such circumstance. The notification will be directed to the Regional Director who will then follow the normal steps for disbursement of any sovereign guaranteed loan.
- shall request, and deliver to, the Bank no later than five (5) days after giving such notice, a Demand under Guarantee in an amount equal to the Guaranteed Amounts which remains unpaid at the date of such demand.

Within five (5) days after the Bank's receipt of the Demand under Guarantee, the Bank shall deposit the Relevant Amount into an account designated for that purpose, following which the Principal Paying Agent will make payments on behalf of the GOS to the holders of the New Discount Bonds.

5.1.5 Acceleration of the Guarantee: Following the failure of the GOS to make any payment under the New Discount Bonds, the Bank may elect to pay any amount up to US$ 10m in that respect. The Bank would like to preserve this option in the case of default by Seychelles, followed by a protracted disagreement between GOS and Seychelles creditors. The Bank will advise all the involved parties if it decides to accelerate the guarantee. Under no circumstances can the Bank be obligated by bondholders to pay amounts not yet in default under the guarantee agreement.

5.1.6 On the basis of the principle of pricing neutrality between loans and guarantees, the Bank will apply the same fees to this PBPCG as the lending spread applied to the PBL disbursed in the context of the Economic Reform Governance Program. Hence, the Guarantee fees will be set at 40 bps per annum of the outstanding guarantee amount. No other fees are applicable.

5.1.7 At any point in time, if the guarantee is called, the amount disbursed under the Guarantee will be converted into a loan starting on the interest payment date when the missed payment occurred. The loan will have a maximum maturity of 20 years from the date of signature of the Guarantee Deed and interest will be paid semi-annually. If a default occurs within 15 years from the signature of the Guarantee Deed, a grace period of 5 years will apply. The principal repayments will be in equal semi-annual instalments after the expiration of the grace period. Any call on the guarantee occurring after 15 years will result in a loan whose principal will be repaid in a single bullet payment at maturity. The other terms and conditions will be similar to those applicable to any Policy based loan at the time of the call.

5.2 Financial Analysis of the Monetary value of the Policy Based Partial Credit Guarantee

5.2.1 A financial analysis of the guarantee has been conducted to ascertain its monetary value, under the assumptions of New Discount Bonds issued with US$ 135.5m notional amount. The approach is consistent with the one used by Seychelles' financial advisors. They have indicated that the rating agencies will follow a similar methodology. Management also conducted informal discussions with Fitch ratings who will rate the transaction.

5.2.2. The analysis consists of calculating the value of the guarantee in absolute US$ amount, obtaining the present value of the cash flows of the New Discount Bonds using different discount rates. For cash flows that fall under the guarantee, and that therefore reflect ADB AAA risk rating, a discount rate of 3.95%[8] is used. For cash flows that reflect Seychelles' risk, the assumptions provided by Seychelles Advisors are used: a decreasing yield profile that starts at 50% and over time decreases to pre-default levels of 10%[9]. The difference between the present value of the cash flows that reflect exclusively Seychelles' risk ((b) in table 3) and both Seychelles and ADB risks ((a) in table 3) is the absolute guarantee value ((c) in table 3).

5.2.3. The relative value of the guarantee is the ratio given by absolute guarantee value/ notional amount of the New Discount Bonds. The notional amount is used because the exchanged bond will be issued at par. This value varies between 17.30% (in the best case scenario) and 1.85% (in the worst case scenario) ((d) in the table 3). The resulting estimated haircut under the two scenarios is respectively 56% and 64%. This is significantly above the target of 45% required to achieve comparable terms granted by the Paris Club.

5.2.4. The results presented in Table 3 refer to two scenarios. In the worst case scenario, which assumes that Seychelles defaults immediately after the bond exchange, the Bank guarantee will cover the first 4 coupons and a portion of the 5th interest payment. In this scenario, the value of the guarantee is circa 1.85% of the notional of the transaction and the underlying Seychelles credit exposure is almost 99%. The best case scenario assumes that the GOS always honours its interest payments and the guarantee will roll over from one interest payment to another until the maturity of the bond. In that case, the value of the guarantee is 17.30% and the underlying Seychelles credit exposure is roughly 82%. Investors' perception of the value of the guarantee will fall in the range of 1.85% to 17.30% and reflect their assessment of Seychelles' creditworthiness.

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[8] The discount rate is calculated under the assumption of a 10 year US$ swap rate of 3.65% and an ADB funding margin of 30bps.

[9] The current implied yield is around 100%, based on a trading price of approximately 28% on the defaulted issue. Before the default, the Seychelles implied yield was trading at around 10%. The Seychelles discount rate profile as per Seychelles Advisors' assumptions is in Annex 9.

5.2.5. An independent assessment of the guarantee value will be provided by rating Agencies. Fitch ratings will rate both the country on a standalone basis and the bond issue with the Bank's guarantee. Fitch will look at the coverage ratio of the guarantee (calculated as the guarantee amount divided by the notional amount of the New Discount Bonds) and indicated that a rating uplift resulting from a guarantee takes into consideration several parameters including but not limited to subrogation rights, acceleration of the guarantee and coverage. When the coverage falls between 5% to 20% of the notional amount of the bond issue, this typically results in one notch uplift. In this transaction, the coverage is around 7.5%, thus Management expects a one notch uplift of the New Discount Bonds rating, compared to Seychelles stand alone rating expected to be on the lower end of the B rating scale.

Table 3: Scenarios Best/Worst cases

	Best Case Scenario	Worst Case Scenario
Cashflows with Guarantee (a)	118.48	97.54
Cashflows without Guarantee (b)	95.04	95.04
Absolute Guarantee value (c) = a – b	23.44	2.50
Relative Guarantee Value (d) =(c) /Notional Amount (%)	17.30%	1.85%
Estimated sovereign debt haircut in NPV terms	56%	64%

All figures are in US$ millions unless otherwise stated. These calculations are net of guarantee fees to be paid by the Seychelles to the Bank.

VI. PROGRAMME BENEFITS AND IMPACTS

6.1. Programme beneficiaries

6.1.1. **The primary beneficiaries are the Seychellois people**. The guarantee will directly enhance the chances of commercial creditors participating in debt restructuring and, therefore, help reduce the public debt burden. This would, in turn, release resources to allow the GoS to pursue its development goals.

6.1.2. Since the start of discussions with **commercial creditors**, these creditors have pressed for additional concessions from the GoS, whether these take the form of higher coupons, lower principal haircuts and shorter repayment periods. In certain cases, creditors have asked for additional sweeteners, such as GDP warrants, equity in state-owned enterprises, options and even islands. It was in response to these pressures that the GoS conceived the partial guarantee as a way of providing **additional value to creditors** and without placing further strain on government cash flows.

6.1.3. This type of operation has not been done before by another IFI and, as such, is an innovative way to support Seychelles' in its debt restructuring. By approving this PBPCG, the Bank demonstrates its ability to be client focussed, innovative and responsive – this will have **positive reputational effects for the Bank**.

6.2. Impacts on environment

6.2.1. **This programme has been classified under category III of the Bank's environmental classification.** The programme is not expected to generate any negative impacts on the environment since it focuses on improving financial governance and reducing the countries debt burden through facilitating commercial debt restructuring.

VII. MONITORING AND EVALUATION ARRANGEMENTS

7.1. Programme

7.1.1. **Institution responsible:** Ministry of Finance (MoF)

7.1.2. **Monitoring system:** Programme implementation monitoring will rely on the IMF periodic reviews of the EFF and joint World Bank/ADB review missions of the budget support operations. MoF will be in charge of collecting, from appropriate sources, the data necessary to assess implementation progress.

7.1.3. **Evaluation system:** Joint reviews between MoF, IMF, World Bank and the ADB will aim to identify the main strengths and weaknesses of the reform programme, possible areas of assistance to sustain momentum towards government's planned medium-term structural reform programme, and address potential downside risks.

VIII. LEGAL DOCUMENTATION AND AUTHORITY

8.1. Legal documentation

8.1.1. The legal documents pertaining to this transaction will be based on the following three (3) main documents:

(i) **A Counter Indemnity Agreement (CIA)** to be signed between the Republic of Seychelles (RoS) and the Bank. The CIA will stipulate the terms under which the Bank will provide its partial support by entering into the Deed of Guarantee (DG);

(ii) **A Deed of Guarantee (DG)** to be signed between the RoS (as Issuer), the Bank (as Guarantor), Deutsche Trustee Company Limited (as Trustee) and the AG London Branch (as Principal Paying Agent). The DG will provide that the ADB's guarantee is unconditional and irrevocable for an amount not exceeding US$ 10m and limited to interest payments and not principal. The guarantee will be rolling and not re-instatable. Therefore, at any coupon payment date, if RoS makes a coupon payment, the guarantee will roll to the next outstanding coupon; and

(iii) **The Prospectus (or Exchange Offer Document)** is essential to the transaction as it will disclose the context of the transaction and the type, substance and limitations of the Bank's commitment. The prospectus will be filed with the Financial Services Authority (FSA) in the United Kingdom (UK) as is the case for any listed transaction on the London Stock Exchange.

8.2. Conditions associated with the Bank Group intervention

8.2.1. This policy based partial credit guarantee is complementary to the recent budget support operation approved by the Board of Directors of the Bank for Seychelles in July 2009. This transaction targets a reduction of commercial debt comparable to what was agreed at the Paris Club, while the budget support operation aims to contribute to overall public debt sustainability.

8.3. Compliance with Bank Group policies

8.3.1. The applicable Bank policies include inter alia (i) *Bank policy on Policy based lending* and (ii) *Guidelines on Bank Guarantees*.

8.3.2. Given that the DG is irrevocable and unconditional, it is requested that the Board grants a waiver to the revised policy on loan arrears recovery

IX. RISK MANAGEMENT

9.1. **Reputational risk to the Bank of a guarantee operation that supports debt restructuring.** The guarantee is to be applied to restructured bonds that Seychelles has previously defaulted on. Firstly, questions may arise as to why the Bank is guaranteeing an uncertain sovereign risk. Secondly, there may be concern that the Bank's participation in this debt restructuring operation will convey the wrong message to bond holders and other interested parties – that the Bank condones this type of operation when in fact the Bank normally emphasises full reimbursement of its own loans and never writes off any of its sovereign operations. Thirdly, given the relatively limited value of the Bank's participation, the bond is likely to only benefit from a one notch rating uplift (to B). This association with the Bank's name may send the wrong signal to the Bank's own investors.

- **Mitigation:** There are a number of mitigation factors – (i) the guarantee amount is limited; (ii) there is a consensus among "multi-lateral agencies" that Seychelles deserves to be supported (moreover, the Bank will work closely with the IMF to monitor Seychelles' commitment to debt management reforms and ensure that appropriate measures are in place to prevent a further default); (iii) the legal documentation and agreements will be drafted in clear and simple language so that there is no ambiguity of the Bank's role; and (iv) to avoid any misrepresentation of the guarantee and safeguard the Bank's reputation, the Bank will ensure that it has direct control over all marketing and communication activities regarding the guarantee and details of the Bank's involvement (e.g. exchange offer press release subject to Bank's prior approval).

9.2. **Setting a precedent for other RMCs by providing a guarantee to Seychelles' commercial debt restructuring.** Given that several RMCs may intend to access international debt and capital markets directly, and at financial terms that may prove unsustainable over the long-term, the Bank's intervention on Seychelles' behalf could create a moral hazard.

- **Mitigation:** One way to counter this potential risk is for the Bank to elaborate a Bank Group Policy that clearly defines the circumstances and limits within which the Bank could provide support to RMC's commercial debt reduction/restructuring efforts and the associated conditionalities. Such requirements could include the existence of an ongoing IMF supported reform programme and an already approved PBL arrangement with the Bank.

9.3. **A prolonged period of slow growth may stall the reform agenda.** In the best of circumstances, the Government had estimated that its reforms would have a negative initial impact on growth, before a strong rebound as the effects of a more efficient public sector, higher investment, and improved access to foreign exchange took hold. A strong recovery was predicated on a strong global economy, which for Seychelles would mean higher tourist inflows as well as FDI. The continued weak global environment augurs poorly for Seychelles in this regard and could well prolong the period required for recovery. There is a concern that this may stall and reverse the reform agenda, as Government seeks to achieve some positive results in the lead up to the 2011 presidential elections.

- **Mitigation:** The authorities continue to show strong commitment to implementing the reform and stabilisation programme, as demonstrated by the upfront measures already taken and their willingness to engage the IMF in a new 3-year Extended Fund Facility (EFF) to support the medium-term structural reform programme. In order to keep abreast of this, the Bank will maintain dialogue with the Government and other partners and undertake active monitoring of the programme to ensure that any issues are highlighted and addressed early. The support of all partners has also already been remarkable.

9.4. **Seychelles defaults again.** Even with a positive response from creditors and given a prolonged global economic downturn Seychelles remains in debt distress and is, thus, unable to meet its debt servicing requirements.

- **Mitigation:** The Seychelles economy is very different to what it was when it previously defaulted. The reform programme continues to be successfully implemented and macroeconomic stabilisation has advanced rapidly. Combined with the measures already adopted by GoS to improve PFM, including public debt management, these will reduce the default risk of the country and strengthen the country's capacity for honouring future debt obligations. In addition, Seychelles has now re-engaged with a number of donors who are actively supporting the reform programme, debt management issues and providing budget support to help fill budgetary gaps.

X. RECOMMENDATION

10.1 **Seychelles has made commendable efforts to reform its economy in recent years.** The critical issue the country faces today is a considerable commercial debt burden. The Bank can be instrumental in assisting the country, through a partial credit guarantee, to successfully negotiate a restructuring of that debt. In addition, this programme will support certain frontloaded reforms to enhance financial governance and debt management.

10.2 It is recommended that the Government of Seychelles be granted a partial credit guarantee not exceeding US$ 10m from the resources of the African Development Bank (ADB), based on the conditions stipulated in this report.

Annex 1: Letter of Development Policy for PBPCG

20th November 2009

H.E. Dr. Donald Kaberuka
President
African Development Bank Group (AfDB)
Tunis Belvedere,
Tunisia

Dear Dr. Kaberuka,

REPUBLIC OF SEYCHELLES

LETTER OF DEVELOPMENT POLICY

1. On behalf of the Government of Seychelles, I write to request approval of the Policy Based Partial Credit Guarantee. This Guarantee will provide critical support to Seychelles in its effort to restructure its external commercial debt through an offer that we plan to launch in a few weeks' time. Completing this offer to exchange a Eurobond issued in 2006 and Amortising Notes issued in 2007 for new bonds with lower coupons, a longer repayment period, and, in some cases, a principal reduction, with a high participation rate is integral to the success of the wide-reaching reform program we launched in October 2008. For if the offer fails our debt will remain one of the very highest in the world as a share of GDP, paying interest and arrears will continue to constrain the fiscal space we need to make social and capital expenditures, and the government's reputation will be ever too close to default for our private sector to attract the investment needed for dynamic growth. Such are the stakes—otherwise I would not ask for this exceptional, time sensitive support.

2. Our reforms have achieved broad based support. As we designed the program, we carefully consulted with our partners in civil society, the opposition, and business. Despite a healthy difference of views among parties, every single reform has been unanimously approved in Parliament. This domestic consensus has been bolstered by the international community, which has long played an important role in our country. In April 2009, the Paris Club group of creditors provided a 45% debt cancellation and 18 year deferral of maturities—an exceptional treatment for a middle income country. The Club's willingness to front load assistance was due in part to the steadfast praise we have received from the International Monetary Fund, which has provided us our first ever borrowing program, a SDR 17.6 million Stand By Arrangement.

3. Early successes of reform implementation are becoming apparent though Seychelles has not been spared the deterioration in the global economy**.** Supported by tight fiscal and

monetary policies, the nominal exchange rate stabilized in late 2008 and has slowly appreciated against the US dollar since Q1 2009. During the last few months, prices have actually declined—a remarkable reversal from last year's average inflation of 37%. External reserve accumulation has been well above target throughout our IMF program, while reserve money was contained by over performance on the fiscal side. Yet our economy depends on tourism, and the global downturn has brought a somewhat startling slowdown.

4. A key component of our reform program is placing our public sector debt on a sustainable footing. Since late 2008 we have engaged our external creditors in discussions about the nature of the problems in the economy and public finances as well as the severe financing shortfalls we face over the next decade. Although the exceptional Paris Club agreement has provided important relief, it covered only about a third of the debt stock that must be restructured to bring our payments in line with medium term capacity. We intend to request holders of capital market instruments to provide debt relief that is comparable to that provided by the Paris Club and in line with our financing projections produced in conjuction with the International Monetary Fund. Although the restructuring discussions have been challenging given the magnitude of relief required to achieve sustainability, we are encouraged by the long term view taken by many of our creditors. The requested guarantee would improve the value of the offer we are making by reducing the risk creditors will apply to the immediate interest payments due. A critical aspect of the guarantee is that we believe its annual cost will be quite small relative to what it would cost the government if the interest rate had to be increased to match the value that creditors have told us they would assign to a guarantee of this nature. In sum, we believe that through this operation the Bank will help us achieve debt relief in a cost effective manner that will allow our debt to be placed on a sustainable footing. After this offer closes successfully, we expect that our remaining financing gaps would be closed.

5. The objective of this Letter of Development Policy (LDP) is to present policy reforms we implemented in 2008 and 2009 which are based on our economic policy frameworks that accompanied 2008 and 2009 budget submissions to our Parliament. The measures we implemented in 2008 and in early 2009 are fully in line with government policies. The President of the Republic earlier this year stated that achieving our reform has been one of the greatest challenges that our country has ever faced. We have requested that the IMF provide an Extended Fund Facility to ensure that we have a medium to long term outlook in our policy focus.

I. SEYCHELLES REFORM PROGRAM

I.1 Overview

6. Over the past two decades Seychelles has successfully promoted social development. In Africa, Seychelles leads in human development with a life expectancy of 72.2 years and high literacy rate of 96.6 percent. It is ranked 50th on the 2007 United Nations Development Program Human Development Index, a level comparable to many OECD countries. However, since the mid-1990s these achievements have been put increasingly at risk due to persistent macroeconomic imbalances, external shocks and long-standing structural problems**.** Current account deficits were high throughout the 1990s and reached 23 percent by 2001. Fiscal deficits also remained high and reached about 20 percent of GDP in 2002; the external debt stock reached almost 85 percent of GDP and Seychelles fell into arrears with some of its creditors. GDP declined by 5.3 percent in 2003 signaling that domestic and external imbalances were having a negative impact on the economy and welfare.

7. Recognizing these challenges, in 2003 we began a reform and modernization effort and introduced a Macro Economic Reform Program (MERP) in June 2003. MERP emphasized a large immediate fiscal adjustment through a combination of revenue increases and expenditure reducing measures. It also included liberalization measures such as a privatization program. As a result the economy started to recover in the latter half of 2005 driven by a sharp increase in tourist arrivals, a construction sector boom financed by record-high foreign direct investment inflows as well as short-term high public spending (during the 2006 election year and in 2007 as election promises were implemented). Real GDP grew by 6.3 percent in 2007. However, the fiscal adjustment was not sustained, and significant internal and external imbalances remained. After a brief period of a near-balanced budget between 2003 and 2005, fiscal performance deteriorated in 2006 and 2007, partly as a result of spending associated with the presidential and parliamentary elections. While there were step devaluations and the exchange rate moved from SR 5.5 to SR 8 per US$1, in the absence of fundamental liberalization of the regime parallel markets continued to flourish with rates of SR 12 or 13 to US$1. Price controls and restrictive regulatory framework remained in effect which hindered private sector growth.

8. The maintenance of a pegged exchange rate, which was not compatible with fiscal and monetary policy, together with pervasive foreign exchange restrictions has led to an overvaluation of the Seychelles rupee, a growing parallel market, and persistent foreign exchange shortages. This in turn has increasingly hampered competitiveness and economic growth. In 2007-08, the global oil and food price shock hit the Seychelles economy particularly hard given its dependence on basic imports, with inflation rising sharply to 38 percent (year-on-year) by August 2008. Notwithstanding gradual adjustment of the exchange rate from 5 to 8 rupees to the US dollar between October 2006 and October 2007, the currency remained overvalued, exchange shortages persisted, and official external reserves were virtually

exhausted. These imbalances came to a head in July 2008 when we missed a payment due on a privately-placed external debt issue. In October 2008, we were unable to make a coupon payment on our outstanding Eurobond. As of the end of June 2009, Seychelles' public sector debt had risen to roughly 150% of GDP, a level that is clearly not sustainable.

II. MAIN ELEMENTS OF POLICY REFORMS

9. This situation called for a radical break with past financial and economic policies. In early November we introduced the following set of fundamental reforms:

- Full liberalization of the foreign exchange regime by floating the Rupee
- Tight fiscal policy backed by public sector reforms and a reduction in direct and indirect subsidies, and public financial management measures.
- Social sector reforms and improved targeting of the social safety net.
- A reform of the role of government and a reduction of the state in the economy through further privatization and improving the investment climate.
- Reform of monetary policy formulation process and the banking system

II.1 Foreign Exchange Regime

10. Following the float of the rupee in early November the exchange rate lost about 60 percent of its value against the U.S. dollar, and it has nominally appreciated since Q1. Monetary policy has been tightened to support the free floatation of the currency. In addition to the exchange rate the trends in other monetary aggregates have showed very encouraging movements, notably the interest rates, which after initially rising strongly—T-bill rates rose to over 29 percent in late December—have fallen to around 3% in October. We have now achieved full convertibility of the Rupee and we are confident that this major regime change will have a positive impact on private sector development in general.

II.2 Fiscal Reforms and Fiscal Policy Framework

11. Strong fiscal adjustment has been and is central to the achievement of debt sustainability and sound public finances. We are committed to implementing a large and sustained fiscal adjustment that will help both anchor the move to a floating exchange rate regime and allow for a gradual reduction in public debt. In 2008 our primary surplus was over 9 percent of GDP—well over the program target of 6.2 percent. These objectives have been

achieved through a combination of expenditure restraint, including the elimination of subsidies and a reduction of the wage bill in real terms (from about 7.9 percent of GDP in 2008 to a forecast of 6.2 percent of GDP in 2010) as part of our plan to reduce the size of the public sector, tax policy measures including the removal of exemptions, strengthened tax administration and public financial management, public sector reform, and further privatization of public enterprises. To consolidate reform, exceptionally high primary surpluses of about 10 percent of GDP will be maintained in 2009-10, easing gradually over the medium term.

12. We have introduced measures to reinforce fiscal revenue and results to date have been encouraging. We have applied the goods and services tax (GST) to all locally-manufactured and imported goods, except for 13 basic food items, and removed discretionary powers to grant exemptions. The following revenue measures have been introduced in the fourth quarter of 2008 as per the schedule below.

Table 1: Revenue Raising Measures Agreed in the MEFP, 2008

Action	Timing
Raise and harmonize taxes on local and imported cigarettes to SR 500 per 200 cigarettes.	October 1, 2008
Introduce 10 percent withholding tax on interest income for residents.	October 1, 2008
Extend GST to all telecom companies.	October 1, 2008
Announce the introduction of the GST of 15 percent on residential rental income, effective January 1, 2009.	October 10, 2008
Announce the removal of the exemption on interest income by companies (Tax Act) effective January 1, 2009.	November 1, 2008
Reintroduce GST on locally produced soft drinks.	November 1, 2008.
Raise GST on tourism services from 7 percent to 10 percent.	November 1, 2008
Raise specific taxes/excise tax rates for both locally manufactured and imported alcohol to adjust for inflation.	November 1, 2008
Raise environmental levy to SR 25 from SR 10 per month per household.	January 1, 2009
Adjust fees, fines, charges and rents and royalties for inflation.	January 1, 2009
Reinstate GST on LPG.	January 1, 2009
Raise GST on tourism services from 10 percent to 12 percent.	November 1, 2009
Repeal all provisions for discretionary exemptions in the Trade Tax and Business Tax Acts	January 1, 2009

As part of the 2009 budget, we have introduced the following revenue measures:

Action	Timing
Raise environmental levy to SR 25 from SR 10 per month per household.	January 1, 2009
Adjust fees, fines, charges and rents and royalties for inflation.	January 1, 2009
Reinstate GST on LPG.	January 1, 2009
Raise GST on tourism services from 10 percent to 12 percent.	November 1, 2009
Repeal all provisions for discretionary exemptions in the Trade Tax and Business Tax Acts	January 1, 2009

13. More frequent adjustments toward cost-recovery levels for water and electricity prices are reducing government subsidies to the public utility company, and petroleum product prices are now adjusted monthly to reflect international prices. Despite inflationary pressures, primary spending has also been contained due to low public sector wage rises and tighter spending controls. Increased tax on fuel and a new import levy on automobiles have more than made up for a shortfall on goods and services tax (GST) due to the elimination of GST on 13 basic food items and cooking gas (LPG).

II.3 Budget Credibility and Public Financial Management Reforms

Strengthening the public financial management framework and the budgetary process is one of our key objectives. In the past the credibility of our budget has been low as budget outcomes have tended to exceed the approved appropriations approved by the Parliament at the beginning of the fiscal by a large margin, as much as 22 percent on average between 2005-2007. This was in part due to the fact that our budgetary process and budget classification systems were outdated and international standards were not used. In order to deal with this issue we have strengthened the budget formulation and execution process by adopting the IMF's GFS classification system and established spending limits for line ministries. We have also strengthened the budget preparation, implementation and monitoring processes, including through the preparation of a consistent medium-term macroeconomic framework by creating a new unit within the Ministry of Finance. These reforms enabled us to better monitor fiscal outturns and improved our budget execution rate which in turn allowed us and to achieve our primary surplus targets as indicated above. The preparation for the 2010 budget is in its final stages and accompanying the budget this year will be the (i) annual borrowing plan (ii) debt management strategy (iii) Macroeconomic assumptions and objectives, fiscal targets and objectives. (iv) the 2008 actual revenues and expenditures of Government (v) the breakdown of capital expenditures (vi). The 2011 and 2012 Budget Projection.

II. 4 Public Sector Reforms and Reforming the Role of the State

14. Our main objective in this area is to transform the role of the State to one of provider of efficient public administration and public goods and services. This required action in three areas. First, Seychelles needed to reduce the size of its public administration and our analysis of the situation has shown that this was critical for attaining fiscal sustainability. Prior to reforms public administration accounted for over 40 percent of total employment, a large figure by small island standards. The Manpower Budgeting Exercise (MBE) we carried out in 2008 has shown that there was considerable scope for public sector employment rationalization. We aimed to reduce the number of government employees by 12.5 percent by early 2009 and by mid 2009 this target was more than achieved. This objective was achieved through three schemes. First, under the MBE we reduced the projected wage bill overrun from SR 17.8 million to 4 million. Second, an early retirement scheme was also introduced at the beginning of 2008 for civil servants over the age of 55. The scheme has remained open for the remainder of 2009. Third, a voluntary departure scheme has been conducted in October/November 2008, and this was followed by a freeze in non-essential vacancies. Reductions in public employment cut the wage bill from 9.8 percent of GDP to 6.8 percent in 2009 thus generating the budgetary savings in part to attain our primary surplus targets. Those who left government have been provided with a separation package and have been eligible to seek assistance from the newly created Social Welfare Agency as explained in paragraph 19 below. A strategic plan to modernize our public administration was endorsed by cabinet in August and implementation is already underway. As of January 2010 all non-core services previously carried out by the Government will be outsourced.

15. Privatizing commercially oriented enterprises with a view to enable the private sector to assume the lead role in the economy is the second leg of our broader public sector reforms. Reforms in this particular area also include polices to better exercise the ownership of the State and are necessary to achieve fiscal sustainability. We have initially started our privatization program by selling the State Assurance Corporation of Seychelles (SACOS) in June 2006 to a strategic investor and to the public. In 2008 we have focused state owned enterprises that have a distortionary impact on the economy and those that are causing a net fiscal drain. One such parastatal was the former State Marketing Board, a State trading conglomerate and supplier of basic consumer goods, which was closed in February 2008. The former SMB was unbundled in March 2008 and five new different companies were created and some of the assets have been sold in 2008 and the government is committed to complete the sale of former SMB in 2009.

16. We are committed to enforce the highest standards of transparency and accountability in the public and private sectors. A new *Public Debt Management Act was encated in December 2008* establishing procedures and defining roles and responsibilities of agencies involved in debt contracting and management. The Law authorizes the Ministry of Finance as the only body to contract debt. The deficiency in the previous law contributed to the build-up in debt to unsustainable levels. In August 2008 we enacted *the Public Officers Ethics Act,* which provides for a code of conduct and ethics for civil servants, requiring financial declarations and prohibiting conflicts of interest. *The Public Procurement Act*, modeled on the COMESA standard, was enacted in December 2008. The objective of the act is to standardize procurement procedures within the government by modernizing and harmonizing regulations and procedures. Transparency, competitiveness, and efficiency will be enhanced as tender procedures will ensure competitive bidding through strict and uniform requirements regarding minimum number of bidders and public disclosure of all bids. In July 2008, we amended the Anti-Money Laundering (AML) Act to establish a Financial Intelligence Unit with powers of investigation and sanction, and to strengthen the proper enforcement of AML regulations by enabling the Supreme Court to order civil proceedings for the preservation and disposal of proceeds of criminal conduct under the Act. In September, the National Assembly enacted the *Public Enterprise Monitoring Act,* which provides for the Public Enterprise Monitoring Division in the Ministry of Finance to monitor the performance of Public Enterprises.

II. 5 Reforming Social Sectors and Improving Health and Education

17. Our main objective in health and education sectors is to improve efficiency and maintain the standards we attained since independence. We have undertaken reviews in both sectors with the assistance of the Bank and found that there was and there is still considerable potential to make considerable improvements to efficiency in both health and education. This can be achieved by reducing spending on service delivery areas that are underutilized and reducing expenditures on cash transfers that are not well targeted. In health sector reforms have been introduced to substantially reduce the health sector wage bill by identifying and releasing staff in areas of low productivity. The health sector is characterized by low utilization rates comparable to European levels and new measures are being adopted to rationalize facilities. The share of the total health budget spent on hospital care (46 percent) is very high, especially when compared to European countries with more sophisticated hospital care. Seychelles has an oversupply of health care facilities and more hospitals and beds per capita than other middle-income countries. A facilities and staffing review is being undertaken by MOH and Department of Public Administration and based on this review we will begin to rationalize our health facilities.

18. Improving efficiency and generating savings without reducing overall education spending is one of the main goals of our government. Recent reviews, both by the government and our development partners have shown that quality and examinations results are issues as many candidates do not pass exams. We will not reduce budgetary allocation to this sector but instead expenditure improvements will be largely re-invested in sector reforms aimed at increasing quality of education and education outcomes. Most public education spending is

principally on wages and salaries and this is also where most potential to improve efficiency of spending by removing unproductive posts. We have carried out strategic staffing reductions and reduced office staff in MOE and by contracting out school cleaning and meal provision has been able to reach the target of 12.5 percent reduction of the wage bill. Savings generated from these reforms is being spent on measures to improve the quality of education and the MOE will focus on results and is in the process of developing a new strategy.

19. We have replaced costly and inefficient direct and indirect product subsidies with a well-targeted social safety net. The universal subsidy scheme our government provided over the past two decades was too generous and it proved to be inefficient. We have eliminated the subsidies indicated below and established a Social Welfare Agency in October 2008.

Action	**Timing**
Abolish fishermen fuel subsidy coupons.	October 1, 2008
Eliminate indirect universal product subsidies and replace with a targeted social safety net by enacting the Welfare Agency Act.	November 1, 2008
Eliminate SR 90 per month electricity rebate for households.	January 1, 2009
Raise and maintain Seychelles Public Transportation Company (SPTC) bus fare at operating cost-recovery levels.	January 1, 2009
Eliminate implicit and explicit subsidies for Agro Industries, Hatcheries, Seychelles Trading Company (STC), and Coetivy Prawns.	January 1, 2009
Eliminate LPG subsidy by the state oil company (SEPEC) (about SR 3 per kg.).	January 1, 2009

The agency will protect the most vulnerable segments of our population that have been hard hit by the rise in inflation, particularly increased food prices, as well those who left their jobs in the public sector. Applicants receive a response within 3-7 days and our initial assessment is that the agency is working reasonably well as it has been able to provide assistance to those who left the public sector.

Conclusion

Completing the exchange offer that this operation supports will not be easy. The cuts and extensions we will ask for are likely to amount to write-offs of well over 50% in net present value terms. Yet I can tell you that even in the face of losses I believe our creditors will stand with us. They will stand with us because we have taken the time to meet them and square the reduction in cash flows with the reality of the very limited payment capacity in our projections produced with the International Monetary Fund. Although many have come to us in hopes of coupon concessions and side deals that we simply cannot afford, I believe they have been left with a sense of situation on the ground, and this knowledge of where we are going will encourage them to tender their bonds.

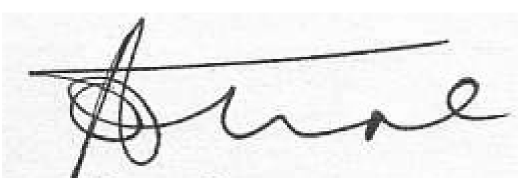
For the reforms have been far reaching, and they have been painful. Yet we are about to launch a second wave of transformation to improve our tax system and institutions and unearth the interests that have time and again been quicksand to change and private sector driven-growth. I believe that our commitment to not just rebuild the foundations but to lay down bedrock has been noticed. We are ahead of the IMF's schedule and have achieved fiscal targets that are multiples of those of other SBA borrowers because we know we have a long way to go.

I also think the manner in which the international community has stood with us will play a role in encouraging bondholders to provide debt relief. Back in April when the impact of the global downturn on our already troubled economy was just beginning to emerge and our reform record was only six months long, Paris Club creditors provided a 45% writeoff and long term extension of our debts. In July the Bank led the way among multilateral and bilateral partners with the EGRP, showing unqualified support for our reform program and a commitment to turn the page with us. A few weeks ago the World Bank followed suit, and we do believe the review scheduled by the International Monetary Fund in a few weeks will be a categorical success.

In this operation we have asked the Bank to commit its expertise in the field of sovereign lending and its reputation as a trusted, market-leading actor to help us close a critical exchange and achieve debt relief in a manner that is cost effective and consistent with our long term payment capacity. Where other institutions might have shied at the innovative nature of the transaction or the ambitious, private sector-driven timeline, the African Development Bank did not. The technical expertise and ideas the Bank's staff have shown in structuring this guarantee will without doubt, add to creditors' support. We consider ourselves fortunate to have such an institution at hand in our greatest time of need.

The government of the Republic of Seychelles requests that this Policy Based Partial Credit Guarantee be approved.

Yours Sincerely



Danny Faure
Designated Minister and Minister for Finance
Republic of Seychelles

Annex 2: Operations Policy Matrix

Medium Term Policy Objectives	Policy Actions (outputs)		Indicators	Base line data (year 2009)	Indicators' targets		Responsible Institutions
	2009	*2010*			*2009*	*2010*	
Strengthening Public Debt Management							
Public debt Management is improved	Negotiate and reach an agreement with external commercial creditors on debt relief terms	Manage the agreement	Official notification letter from GoS indicating successful commercial debt restructuring	No debt relief agreement with commercial creditors	Debt relief agreement reached	Debt relief agreement reached	Ministry of Finance
	Prepare the Medium Term Debt management Strategy	Implement the Medium Term Debt management Strategy	The Medium Term Debt management Strategy	No Medium Term Debt management Strategy	The Medium Term Debt management Strategy prepared	The Medium Term Debt management Strategy approved	Ministry of Finance
	Prepare the annual Borrowing Plan for Budget year 2010	Prepare the annual Borrowing Plan for Budget year 2011	Annual Borrowing Plan	No annual Borrowing Plan	Draft Annual Borrowing Plan for Budget year 2010 is ready	Draft Annual Borrowing Plan for Budget year 2011 is ready	Ministry of Finance

Annex 3: IMF Press Release after 3rd review under SBA

IMF Announces Staff Level Agreement with Seychelles on a 3-year Successor Arrangement under the Extended Fund Facility

Press Release No. 09/[xxx]
October 30, 2009

An IMF mission led by Mr. Paul Mathieu visited Victoria during October 19-November 2 to assess performance at end-September for the third review under the Stand-by Arrangement and discuss a new 3-year arrangement under the Extended Fund Facility. The mission met with His Excellency President James Michel, Minister of Finance Danny Faure, and Governor of the Central Bank of Seychelles Pierre Laporte, as well other members of government and representatives of the private sector, parliamentarians, and civil society.

At the conclusion of the visit, the mission issued the following statement:

"An IMF mission and the Seychelles authorities have reached agreement, subject to approval by IMF Management and the Executive Board, on the third Stand-by Arrangement (SBA) review as well as on a successor 3-year arrangement under the Extended Fund Facility (EFF), to replace the current SBA. All the end-September quantitative performance criteria and structural benchmarks were met with margins."

"Rapid progress has been made on restoring macroeconomic stability, the result of the liberalization of the exchange regime, strong fiscal adjustment, and prudent monetary policies. Program implementation has been exemplary, even in the face of strong head winds from the global recession. Strong ownership and broad public support for the reforms have been the keys to the program's success. Inflation has been near zero since March and the exchange rate has appreciated steadily from lows early in the year. Official external reserves continue to recover from near depleted levels. The economy is responding well to the reforms and the contraction in economic activity will be somewhat less than previously forecast, with real GDP now expected to decline 7.5% in 2009. The economic recovery is expected to strengthen, with economic growth rising to 4 percent in 2010"."

"The focus now shifts to implementation of a second generation of reforms aimed at putting public finances on a sustainable footing and durably raising growth. The key program objectives are to consolidate macroeconomic stability, remove constraints to growth and improve the performance of the public sector. The reforms include a fundamental overhaul of the tax system, improved management of government finances and performance of public enterprises, and strengthening the financial system."

"Good progress is being made in discussions with external creditors aimed at achieving a comprehensive restructuring of Seychelles' unsustainable public external debt. The mission encourages the authorities to press ahead with their debt restructuring strategy."

"SDR 2.2 million (US$3.4 million) will be available upon completion of the third SBA review. Access under the EFF arrangement is proposed at 225 percent (SDR 19.8 million; about US$30.3 million) of Seychelles' IMF quota with 10 percent of quota disbursed upon approval of the arrangement. The first program review under the EFF will be based on end-March 2010 performance, which is expected to be completed in June 2010."

Annex 4: Selected Economic and Financial Indicators

	2005	2006	2007	2008		2009		2010	2011	2012	2013
	Actuals			Prog.	Est.	Prog.	Proj.	Projections			
	(Annual percentage change, unless otherwise indicated)										
National income and prices											
Nominal GDP (millions of Seychelles rupees)	4,861	5,342	6,113	7,878	7,925	9,970	9,650	11624	12741	13844	14957
Real GDP	7.5	8.3	7.3	3.1	0.1	-0.5	-9.6	2.6	3.8	5.4	5
CPI (annual average)	0.6	-1.9	5.3	32.2	37	33.8	39.2	17.9	5.8	3.2	3
CPI (end-of-period)	-1.1	0.5	16.8	38.8	63.3	21.6	16.3	11.5	3	3	3
GDP deflator average	-2.1	1.5	6.7	25	29.6	27.2	34.7	17.5	5.6	3.1	2.9
	(Annual change in percent of beginning-of-period broad money, unless otherwise indicated)										
Money and credit											
Net claims on private sector	1.9	0.4	9.3	12.5	25.3	7.4	13.1	... ...	... ...	... ...	... ...
Broad money (M2(p)) [1]	1.7	3.0	-14.9	2.6	3.2	30.4	28	... ...	... ...	... ...	... ...
Reserve money (percentage change)	3.4	32.7	-23.1	3.4	0.6	20.4	20.6	...	...	...	...
Velocity (GDP/average M2)	1	1.1	1.5	1.9	1.9	1.8	1.8	...	...	...	...
Money multiplier (M2/reserve money)	4.5	3.5	3.6	3.6	3.7	3.9	4	...	...	...	...
	(Percent of GDP)										
External savings	19.7	13.9	23.4	28.8	32.1	20.9	29.3	24.6	25.8	23.2	22.5
Gross national savings	14.6	14.2	9.1	4.9	3.9	9.7	2.2	6.4	8.2	12	13.9
Of which : government savings	6	0.5	-4.9	3.1	4.6	0.3	-2.2	2.8	3.6	7.6	8.3
Gross investment	34.3	28.1	32.5	33.6	36	30.6	31.5	31.1	34	35.1	36.5
Of which : government investment	5.3	8.1	6.1	4.1	2.3	3.6	3.7	5.2	6.9	7.3	7.8
Government budget											
Total revenue, excluding grants	41.1	42	35.9	35.4	36.2	35.5	35.1	34.7	34.2	34.8	35
Identified expenditure and net lending	40.4	49.6	46	37.6	43.9	41.8	40.1	36.8	37.5	34.5	34.6
Current expenditure	35.1	41.5	40.8	32.2	31.6	35.3	37.3	32	30.6	27.2	26.8
Capital expenditure and net lending	5.3	8	5.1	5.4	12.4	3.6	-0.3	2.7	6.9	7.3	7.8
Overall balance, including grants	1.7	-6.2	-9.7	-1.8	-3.7	-6.1	-4.8	-2.0	-3.3	0.3	0.5
Primary balance [2]	7.3	-0.6	-2.3	7.1	4.2	6.2	9.8	8.2	4.5	4.2	4.0
Total public debt 3	147.1	139.5	146	151.3	149.3	161.3	177.8	146.7	140.3	133.4	125.4
Domestic	100.5	85.8	74.1	53.5	57.8	41.5	44.2	33.2	28.4	24.7	22.2
External 3	46.6	53.7	71.9	97.8	91.4	119.8	133.6	113.4	111.9	108.8	103.2
External sector											
Current account balance including official transfers [4]	-19.7	-13.9	-23.4	-28.8	-32.1	-20.9	-29.3	-24.6	-25.8	-23.2	-22.5
Total stock of arrears (millions of U.S. dollars)	184	123.5	160.4	330.6	309.6	...	...	...	...	...	...
Total stock of arrears	20.8	12.8	17.6	38.5	37.1	...	...	...	...	...	...
Total external debt outstanding (millions of U.S. dollars) [5]	486	521	710.2	840.5	762.6	879.6	805.6	858.2	898.2	933.5	943.6
Total external debt outstanding [5]	55	53.8	77.9	97.8	91.4	119.8	133.6	113.4	111.9	108.8	103.2
Terms of trade (= -deterioration)	4.4	-0.2	-1.2	2.1	0.4	2.4	-3.1	2.5	1.1	0.5	0.5
Real effective exchange rate (end-of-period)	-2.3	-4	-19.7	-8.5	-8.5	...	...	...	...	...	...
	(Millions of U.S. dollars, unless otherwise indicated)										
Gross official reserves (end of year) [6]	56.1	112.7	9.8	18.7	50.9	79.7	90.9	140.9	190.9	240.9	270.9
In months of imports, c.i.f.	0.7	1.3	0.1	0.2	0.7	0.8	1.2	1.7	2.2	2.6	2.8
Exchange rate											
Seychelles rupees per US$1 (end of period)	5.5	5.8	8	8	16.6	...	...	...	...	...	...
Seychelles rupees per US$1 (period average)	5.5	5.5	6.7	8	9.5	...	...	...	...	...	...

Sources: Central Bank of Seychelles, Ministry of Finance and IMF staff estimates and projections, March 2009

[1] In 2007 and earlier, M2 plus domestic currency balances earmarked for pending import requests (pipeline).

[2] The CBS transferred SR 175 million (2.2% of GDP) in profit to the Government in March 2008. Of this amount, SR 118.7 million (1.5% of GDP) was revaluation gains.

[3] Including arrears.

[4] The 2005 current account balance reflects of the import of two tankers. High inflows of FDI associated with specific projects in 2005 and 2008 also contribute to high current account balances in those years.

[5] Includes external debt of the Central Bank.

[6] Starting with 2007 refers to CBS gross international reserves net of blocked deposits and project accounts.

Annex 5: Seychelles – Consolidated Government Operations, 2007-2010
(millions of SCR)

	2007	2008		2008		2009								2009		2010
	Year	Q4		Year		Q1		Q2		Q3		Q4		Year		Year
	Act.	Prog.	Actual	Prog.	Actual	Prog.	Proj.	Prog.	Proj.	Prog.	Proj.	Prog.	Proj.	Prog.	Proj.	Proj.
Total revenue and grants	2214.2	849.5	1147.5	2826.6	3189.7	826.2	917.0	759.4	726.3	925.2	848.6	1052.9	918.6	3563.6	3410.5	4038.7
Total revenue	2197.5	845.5	866.7	2786.1	2868.5	821.2	912.0	754.4	721.3	920.2	843.6	1047.9	913.6	3543.6	3390.5	4038.7
Tax	1896.4	711.2	758.9	2344.5	2456.3	695.8	779.2	702.8	622.8	848.8	711.6	886.0	740.9	3133.5	2854.5	3400.3
Social security tax	301.3	64.4	77.7	320.8	294.9	77.4	77.4	88.0	88.0	91.5	91.5	95.0	91.5	352.0	348.4	419.7
Trade tax	265.2	160.0	131.7	424.0	409.6	115.0	90.7	132.3	104.3	155.3	122.5	172.5	136.1	575.0	453.6	511.6
Goods and services tax (GST)	799.6	292.3	300.4	916.2	950.6	336.4	256.3	343.5	286.1	352.5	293.2	409.6	323.0	1442.0	1158.6	1450.4
Business tax	360.5	150.0	130.0	516.8	524.0	106.1	115.0	107.8	110.0	168.7	170.0	168.5	156.0	551.0	551.0	663.7
Other	169.8	44.5	119.1	166.7	277.3	60.9	239.7	31.3	34.4	80.9	34.4	40.4	34.4	213.5	342.9	355.0
Nontax	301.1	134.3	107.9	441.7	412.2	125.4	132.8	51.6	98.5	71.4	132.0	161.9	172.7	410.2	536.0	638.4
Fees and charges	175.8	35.5	51.9	125.4	145.3	43.1	48.5	41.0	39.6	38.9	48.5	42.1	61.4	165.0	198.1	280.9
Dividends from parastatals	94.8	89.6	47.7	111.8	64.1	0.0	0.0	0.0	0.0	16.0	16.0	107.0	94.0	123.0	110.0	110.0
Other[2]	30.5	9.2	8.3	204.5	202.7	82.3	84.3	10.6	58.9	16.4	67.4	12.8	17.3	122.2	227.9	247.5
External grants	16.7	4.0	280.7	40.4	321.2	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	20.0	20.0	0.0
Expenditure and net lending	2810.2	1078.1	1114.6	2965.4	3482.9	1000.6	942.5	1145.7	1085.8	950.8	845.6	1073.8	999.0	4171.0	3872.9	4273.4
Current expenditure	2497.2	896.0	836.8	2540.4	2503.5	829.1	864.2	963.6	999.1	804.7	797.7	917.2	942.6	3514.6	3603.5	3714.8
Primary current expenditure	2041.4	526.5	537.2	1841.2	1874.6	581.7	546.6	561.7	544.8	568.3	545.8	573.5	558.3	2285.2	2195.5	2527.5
Wages and salaries	699.7	238.0	185.5	720.6	688.1	206.9	184.4	180.1	168.6	180.1	168.6	180.1	168.6	747.2	690.3	704.1
Goods and services	499.8	134.9	162.7	447.0	488.8	146.7	153.8	151.9	160.8	161.2	160.8	165.3	172.2	625.0	647.6	830.1
Interest payments due	455.8	369.5	299.6	699.1	628.9	247.4	317.6	402.0	454.2	236.4	251.8	343.7	384.3	1229.4	1407.9	1187.3
Foreign interest[3]	219.4	191.0	191.3	343.7	343.8	43.8	47.9	196.3	216.9	41.0	45.2	181.4	208.4	462.5	518.4	477.6
Domestic interest	236.4	178.5	108.4	355.4	285.1	203.5	269.7	205.7	237.3	195.4	206.7	162.3	175.9	766.9	889.6	709.7
Transfers	833.6	150.3	187.3	667.6	692.0	226.2	205.9	227.7	212.9	225.0	213.9	226.1	214.9	905.1	847.4	981.2
Social program of central government	166.7	45.8	55.4	193.5	192.3	88.3	67.0	89.8	74.0	88.3	75.0	89.3	76.0	355.8	292.0	368.3
Transfers to public sector from central government	375.6	29.6	66.3	182.3	220.5	45.6	46.5	45.6	46.5	44.4	46.5	44.5	46.5	180.1	186.1	168.1
Benefits and programs of Social Security Fund	291.3	74.9	65.6	291.8	279.2	92.3	92.3	92.3	92.3	92.3	92.3	92.3	92.3	369.2	369.3	444.8
Other	8.3	3.3	1.7	6.0	5.7	2.0	2.6	2.0	2.6	2.0	2.6	2.0	2.6	8.0	10.2	12.0
Capital expenditure	375.7	167.5	30.5	324.2	183.2	71.5	74.3	82.1	82.7	96.1	94.0	106.7	102.4	356.4	353.4	600.7
Externally financed																
Net lending	-62.7	14.6	247.3	100.8	796.2	0.0	-96.0	0.0	-96.0	0.0	-96.0	0.0	-96.0	0.0	-384.0	-292.0
Contingency[3]						100.0	100.0	100.0	100.0	50.0	50.0	50.0	50.0	300.0	300.0	250.0
Primary balance[2]	**140.2**	**140.8**	**332.5**	**560.3**	**335.7**	**72.9**	**292.2**	**15.7**	**94.7**	**210.8**	**254.8**	**322.8**	**304.0**	**622.0**	**945.6**	**952.6**
Overall balance. commitment basis	-596.0	-228.7	32.8	-138.8	-293.2	-174.4	-25.4	-386.3	-359.5	-25.6	2.9	-20.9	-80.3	-607.4	-462.4	-234.7
Change in arrears	59.4	-0.3	33.8	0.5	31.2	0.0	-61.5	0.0	-50.0	-181.4	-50.0	0.0	-50.0	-181.4	-211.5	0.0
External interest	3.9	0.0	157.8	10.5	166.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Budget	55.5	-0.3	-124.0	-10.0	-135.6	0.0	-61.5	0.0	-50.0	-181.4	-50.0	0.0	-50.0	-181.4	-211.5	0.0
Overall balance. cash basis (after grants)	-536.6	-229.0	66.6	-138.2	-262.0	-174.4	-87.0	-386.3	-409.5	-207.0	-47.1	-20.9	-130.3	-788.8	-673.9	-234.7
Financing	536.6	229.0	-66.6	138.2	262.0	42.9	-35.2	-137.6	-312.8	-7.6	-126.8	-296.3	-278.1	-398.4	-752.9	-535.4
Foreign financing	408.1	232.1	-152.7	147.3	141.6	-150.7	-171.1	-450.0	-515.5	64.4	139.1	-178.1	-190.8	-714.4	-738.2	-334.8
Disbursements	859.4	60.8	0.3	232.6	580.6	70.0	80.0	70.0	80.0	280.0	384.0	70.0	80.0	490.0	624.0	599.3
Project loans	859.4	39.2	0.3	211.0	580.6	70.0	80.0	70.0	80.0	70.0	80.0	70.0	80.0	280.0	320.0	307.3
Program/budget support	0.0	21.6	0.0	21.6	0.0	0.0	0.0	0.0	0.0	210.0	304.0	0.0	0.0	210.0	304.0	292.0
Scheduled amortization	-448.6	-260.3	-259.8	-1621.3	-1630.2	-220.7	-251.1	-520.0	-595.5	-215.6	-244.9	-248.1	-270.8	-1204.4	-1362.2	-934.1
Change in amortization arrears	-2.7	431.6	106.8	1536.0	1191.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt relief	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing. net	-19.5	-144.4	-196.4	-218.6	-253.0	108.1	79.1	276.5	105.8	-174.0	-332.7	-289.0	-257.1	-78.4	-404.9	-400.0
Bank financing	-50.3	-137.2	-292.4	-249.9	-282.8	102.7	75.1	262.6	100.5	-165.3	-316.1	-274.5	-244.2	-74.5	-384.7	-380.0
CBS	27.9	-14.4	-278.0	-70.6	-186.6	10.8	23.7	27.6	31.8	-17.4	-99.8	-28.9	-77.1	-7.8	-121.5	-40.0
Commercial banks	-118.9	-122.8	-14.4	-179.3	-96.2	91.9	51.4	235.0	68.8	-147.9	-216.3	-245.6	-167.1	-66.7	-263.2	-340.0
Nonbank	30.7	-7.2	96.0	31.4	29.8	5.4	4.0	13.8	5.3	-8.7	-16.6	-14.4	-12.9	-3.9	-20.2	-20.0
Privatization and long-term lease of fixed assets	134.3	141.4	94.2	256.0	219.4	85.6	56.8	36.0	96.8	102.0	66.8	170.8	169.8	394.3	390.2	199.4
Statistical discrepancy	13.8	0.0	188.2	-46.4	154.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal financing gap	0.0	0.0	0.0	0.0	0.0	131.5	122.1	523.9	722.3	214.6	173.9	317.2	408.5	1187.2	1426.8	770.2
Memorandum item:																
External debt service due	667.9	451.3	451.1	1965.0	1974.0	264.5	298.9	716.3	812.4	256.6	290.1	429.5	479.2	1666.9	1880.6	1411.7

Source: Ministry of Finance; Social Security Fund; Central Bank of Seychelles (CBS) and IMF staff estimates and projections, March 2009

[1] Includes the central government and the social security system

[2] The CBS transferred SR 175 million (2.2% of GDP) in profit to the Government in March 2008. Of this amount, SR 118.7 million (1.5% of GDP) was revaluation gains.

[3] This is created to cover potential losses in state-controlled financial institution

Annex 6: Seychelles Balance of Payments Scenarios (IMF 2nd review under SBA)

SCENARIO A

Table 2. Seychelles: Balance of Payments Baseline Scenario (Assuming Paris Club Restructuring), 2007-19

(Millions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
		Prel.	Proj.	Proj.									
Current account	-213	-420	-250	-343	-422	-445	-500	-578	-659	-772	-911	-1,082	-1,283
(Percent of GDP)	-21	-46	-37	-45	-51	-48	-50	-53	-56	-61	-66	-73	-80
Trade balance	-175	-386	-146	-187	-172	-142	-127	-119	-104	-100	-97	-97	-92
Income, net	-72	-103	-155	-215	-311	-363	-435	-523	-620	-739	-882	-1,054	-1,262
Of which: interest payments due [1]	-33	-33	-92	-124	-202	-236	-290	-357	-432	-525	-642	-786	-962
Current transfers, net	33	69	52	60	60	61	62	63	65	66	68	70	71
Capital and financial account	261	172	483	380	472	500	561	634	711	822	961	1,132	1,333
Capital account	8	5	37	37	5	5	5	6	6	6	6	6	6
Financial account	254	167	446	342	467	495	555	628	705	816	955	1,126	1,327
Direct investment, net	225	346	183	213	236	239	258	289	301	326	352	381	411
Portfolio investment, net	31	1	0	0	0	0	0	0	0	0	0	0	0
Other investment, net	-2	-180	263	129	232	257	297	339	403	490	602	745	915
Net errors and omissions	-8	101	23	0	0	0	0	0	0	0	0	0	0
Overall balance	40	-147	257	37	50	56	60	56	51	50	50	50	50
Financing	-40	147	-257	-37	-50	-56	-60	-56	-51	-50	-50	-50	-50
Change in net international reserves (increase: –)	49	-27	-54	-37	-50	-56	-60	-56	-51	-50	-50	-50	-50
Change in gross official reserves (increase: –)	49	-36	-58	-50	-50	-50	-50	-50	-50	-50	-50	-50	-50
Prospective liabilities to IMF, net	0	10	4	13	0	-6	-10	-6	-1	0	0	0	0
Other NFA (increase: –)	0	0	-10	0	0	0	0	0	0	0	0	0	0
Exceptional financing	-89	174	-193	0	0	0	0	0	0	0	0	0	0
Change in arrears (increase: +) [3, 4]	-89	174	-333	0	0	0	0	0	0	0	0	0	0
Clearance of arrears		…	140	0	0	0	0	0	0	0	0	0	0
Financing gap [5]	0	0	0	0	0	0	0	0	0	0	0	0	0
Financing gap (before closing)	0.0	0.0	337	273	638	638	783	1,003	1,192	1,466	1,810	2,224	2,740
Memorandum items:													
Gross international reserves (stock, e.o.p.) [6]	10	51	108	158	208	258	308	358	408	458	508	558	608
Months of prospective imports of goods and services	0.1	1	1	1.8	2.3	2.6	3.0	3.2	3.4	3.6	3.7	3.8	3.8
Public external debt [1,4, 6]	710	802	885	1,008	1,229	1,477	1,766	2,088	2,486	2,971	3,572	4,318	5,233
(Percent of GDP)	69.2	87	130	132.3	147.5	161.0	175.1	191.7	211.1	233.6	259.9	290.8	326.2
Of which: arrears [1, 3,4]	160	333	0	0	0	0	0	0	0	0	0	0	0
(Percent of GDP)	15.6	36	0	0	0	0	0	0	0	0	0	0	0
GDP	1,026	921	679	762	833	918	1,009	1,090	1,177	1,272	1,374	1,485	1,604

Sources: Central Bank of Seychelles; Ministry of Finance; and IMF staff estimates and projections.

[1] Projections are based on identified new borrowing and rescheduled Paris Club debt. It assumes comparable cash flow treatment for one bilateral creditor that also signed the agreement, and no debt restructuring for the remaining creditors. Arrears restructuring leads to higher rescheduled interest payments.

[2] Based on Paris Club agreement, the payments of principal and most interest during 2008 and through June 2009 are deferred.

[3] In 2008, includes accelerated amortizing notes.

[4] Debt forgivenesss reflects: (i) the first stage of debt reduction (about 22.5) percent in July 2009; (ii) the second stage reduction (about 22.5 percent) in July 2010 on Paris Club debt and one bilateral creditor. Assumes debt reduction comparable to the Paris Club agreement on

[5] Financing gaps are assumed to be closed by a hypothetical 3-year maturity amortizing loan at libor plus 13 percent.

[6] Starting with 2007, refers to CBS gross international reserves net of blocked deposits and project accounts.

SCENARIO B

Table 3. Seychelles: Balance of Payments Alternative Scenario (Assuming Comparibility of Treatment for other Creditors), 2007–19

(Millions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
		Prel.	Proj.	Proj.									
Current account	-213	-420	-195	-240	-240	-230	-234	-249	-260	-279	-303	-331	-346
(Percent of GDP)	-21	-46	-29	-31	-29	-25	-23	-23	-22	-22	-22	-22	-22
Trade balance	-175	-386	-146	-187	-172	-142	-127	-119	-104	-100	-97	-97	-92
Income, net	-72	-103	-101	-112	-129	-149	-169	-194	-221	-246	-274	-303	-325
Of which: interest payments due [1]	-33	-33	-25	-21	-21	-23	-25	-29	-34	-34	-36	-37	-28
Current transfers, net	33	69	52	60	60	61	62	63	65	66	68	70	71
General government, net	10	43	27	35	35	36	36	37	38	39	39	40	41
Other sectors, net	23	26	25	25	25	26	26	27	27	28	29	29	30
Capital and financial account	261	172	231	280	298	291	299	318	320	341	362	385	413
Capital account	8	5	158	158	5	5	5	6	6	6	6	6	6
Financial account	254	167	73	122	293	286	294	311	314	335	356	379	407
Direct investment, net	225	346	183	213	236	239	258	289	301	326	352	381	411
Portfolio investment, net	31	1	0	0	0	0	0	0	0	0	0	0	0
Other investment, net	-2	-180	-110	-91	58	47	36	22	12	9	4	-2	-5
Net errors and omissions	-8	101	23	0	0	0	0	0	0	0	0	0	0
Overall balance	40	-147	59	40	58	61	65	68	60	62	59	55	66
Financing	-40	147	-59	-40	-58	-61	-65	-68	-60	-62	-59	-55	-66
Change in net international reserves (increase: –)	49	-27	-64	-40	-58	-61	-65	-68	-60	-62	-59	-55	-66
Change in gross official reserves (increase: –)	49	-36	-68	-53	-58	-55	-55	-62	-59	-62	-59	-55	-66
Prospective liabilities to IMF, net	0	10	4	13	0	-6	-10	-6	-1	0	0	0	0
Other NFA (increase: –)	0	0	-10	0	0	0	0	0	0	0	0	0	0
Exceptional financing	-89	174	15	0	0	0	0	0	0	0	0	0	0
Change in arrears (increase: +) [3,4]	-89	174	-333	0	0	0	0	0	0	0	0	0	0
Clearance of arrears		…	348	0	0	0	0	0	0	0	0	0	0
Financing gap [5]	0	0	0	0	0	0	0	0	0	0	0	0	0
Financing gap (before closing)	0	0	-10	0	0	-5	-5	-12	-9	-12	-9	-5	-16
Memorandum items:													
Gross international reserves (stock, e.o.p.) [6]	10	51	119	172	230	285	340	402	461	523	582	637	703
Months of prospective imports of goods and services	0.1	1	1	2.0	2.5	2.9	3.3	3.6	3.9	4.1	4.2	4.3	4.4
Public external debt [1,4,6]	710	802	669	561	599	632	655	659	665	670	672	672	668
(Percent of GDP)	69.2	87	99	73.7	71.9	68.9	65.0	60.4	56.5	52.7	48.9	45.2	41.7
Of which: arrears [1,3,4]	160	333	0	0	0	0	0	0	0	0	0	0	0
(Percent of GDP)	15.6	36	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GDP	1,026	921	679	762	833	918	1,009	1,090	1,177	1,272	1,374	1,485	1,604

Sources: Central Bank of Seychelles; Ministry of Finance; and IMF staff estimates and projections.

[1] Projections are based on identified new borrowing and rescheduled Paris Club debt. It assumes restructuring of debt to other creditors on comparable cash flow treatment. Arrears restructuring leads to higher rescheduled interest payments.

[2] Based on Paris Club agreement, the payments of principal and most interest during 2008 and through June 2009 are deferred.

[3] In 2008, includes accelerated promissory notes.

[4] Debt forgivenesss reflects: (i) the first stage of debt reduction (about 22.5) percent in July 2009; (ii) the second stage reduction (about 22.5 percent) in July 2010 on Paris Club debt. Assumes debt reduction comparable to the Paris Club agreement on

[5] Negative financing gaps (surpluses) are added to official reserves.

[6] Starting with 2007, refers to CBS gross international reserves net of blocked deposits and project accounts.

Annex 7: General and technical preconditions for an ADB Partial Guarantee

Preconditions	Observations for Seychelles
General Prerequisites	
Political stability	▪ **Social peace and political stability**: elections held in 2006 were deemed to be free and fair by the International community.
Economic stability and Government's commitment	▪ Previous macroeconomic imbalances should be corrected (as per IMF projections) from the second semester 2009, as the economy reaps the benefits of the reform programme introduced in October 2008. ▪ **Strong political consensus & commitment for implementation of reform agenda:** A clear track record of successful and speedy implementation of the frontloaded reform programme since late 2008, in compliance with the IMF Stand-By Agreement (SBA), demonstrates this commitment.
Technical Prerequisites	
Existence of well designed PRSP or NDP and effective implementation mechanisms	▪ In March 2007, the GoS formulated a NDP (Seychelles Strategy 2017). In October 2008, GoS also formulated a comprehensive and credible macroeconomic and financial reform programme to rebalance the economy. The latter is the basis on which the IMF has designed its ongoing SBA. Implementation of the GoS's reform programme is coordinated by the Ministry of Finance. Moreover, progress on the reform agenda is reviewed by the IMF each quarter. The NDP will be revised accordingly to address the new economic challenges.
Successful reform programme implementation	▪ The programme includes (i) the liberalisation of the currency exchange regime, involving the elimination of all exchange restrictions and a float of the rupee; (ii) a significant and sustained tightening of fiscal policy backed by a reduction in public employment and the replacement of indirect subsidies with a targeted social safety net; (iii) a reform of the monetary policy framework to focus on liquidity management based on indirect instruments; and (iv) a reduction in the role of the state in the economy to boost private sector development, through further privatisation and enhanced fiscal governance, and a review of the tax regime. ▪ The reform programme continues to be successfully implemented. Both the second and third review under the IMF SBA (June and November 2009) concluded that the programme is on track and macroeconomic stabilisation has advanced rapidly, as a result of the liberalization of the exchange regime, strong fiscal adjustment and prudent monetary policies. ▪ The government intends to continue to consolidate macroeconomic stability by maintaining a tight fiscal policy, and progressively putting in place supporting structural reforms to remove constraints to growth and improve the performance of the public sector. ▪ Progress on reducing inflation, in conjunction with the appreciation of the Rupee, has permitted a gradual easing of monetary policy. ▪ The preparation of a fundamental reform of the tax system is proceeding and aims to harmonise rates, broaden the tax base and raise self-compliance. ▪ The preparation of a major reinforcement of control over parastatal performance, as well as further privatisation of a number of state-owned companies and a strengthening of the financial system are also proceeding.
Viable macro-economic and financial medium term framework	▪ The medium-term Fiscal Framework will be finalized in the context of the 2010 Budget. The, medium term fiscal projections made in the context of the IMF's SBA show that it is viable.
Strong partnership between: (i) RMC and donors and (ii) amongst donors	▪ Following the approval of the SBA by the IMF in November 2008, a strong partnership arrangement between Seychelles and its development partners is emerging. Joint missions by the Bank, the IMF, the World Bank, the EC and UN agencies, since January 2009, demonstrate the strong commitment of development partners in coordinating their support to Seychelles' reform programme. A donor forum was also organized in May 2009 to enable development partners, including the Bank to share their views on the ongoing reform programme with the GoS.
Satisfactory fiduciary review of PFM system	▪ Overall, the fiduciary environment is generally satisfactory, as evidenced by the 2008 PEFA Assessment.

Annex 8: Seychelles Strategy 2017

In March 2007, the government introduced a new economic vision for the country: Strategy 2017, with the primary goal of changing the role of the government from being the main engine of growth to one of facilitator of growth. The new strategy is comprehensive in its coverage, covering all levels of government involvement. The Government is committed to doubling GDP by 2017 through focused fisheries and tourism expansion programmes, and the development of the financial services industry. The Government expects the strategy to generate the maximum level of local participation, while enhancing human resource capacity, securing the highest environmental standards, creating efficient and transparent governance and fostering strategic national and international partnerships. As a first step in its implementation, the government has prepared implementation plans for each of the strategic objectives drawn from the guidance of respective stakeholders, but assessing the status of these implementation plans has been difficult as they are not public and lack meaningful targets.

Seychelles Strategy 2017: Summarized Outcomes

I. Macro-foundations	II. Competitiveness and Governance	III. Equity	IV. Sustainability
Sound Macro Management	***Better Business Climate and Good Governance***	***Better Skills, Longer Lives and Monitoring the Vulnerable***	***Improved Infrastructure, Land Management and Biodiversity***
Macroeconomic Framework • Promote a stable and sound macroeconomic framework. **Fiscal Management** • Maintain strict fiscal discipline through fiscal rules. • Reinforce revenue collection policies and re-examine and rationalize the tax regime. • Tie capital budgets to development plans and borrow only to invest, not to fund current spending. **Debt Management** • Gradually reduce total public debt to 60 percent of GDP by 2017. **Public Sector Management** • Reduce the size of government and clarify the role of the civil service. • Use performance criteria to recognize career advancement, training, and remuneration.	**Tourism and Fisheries** • Increase visitor arrivals and per visitor expenditure. • Make Seychelles the primary seafood processing centre of the Indian Ocean. **Offshore Services** • Develop Seychelles as an international jurisdiction for offshore services. • Diversify offshore businesses opportunities with regional oil distribution. **ICT** • Establish a regulatory body to oversee the development of the ICT sector. **Business Environment** • Revamp outdated regulatory practices. **Financial Sector** • Increase the domestic savings ratio and create a stock exchange to help raise domestic investment. **Good Governance** • Promote good governance to guarantee a stable and cohesive social order. • Support an independent judiciary and a re-dynamized police force for the maintenance of peace and stability.	**Education** • Promote training in vocational, managerial and service skills. • Establish an education watchdog to assess and monitor school standard. **Health** • Ensure that those in greatest need continue to receive free health care. • Increase efficiency and improving service delivery standards by outsourcing certain elements of health services. • Provide medical and customer service delivery training to health care professionals. **Social Protection** • Protect the underprivileged and uphold a minimum dignified level of living standard through a compatible minimum wage and hourly wage policy. • Assist sectors of society that are unable to contribute to the national economic growth, through improved social safety-net, bolstered by increased government revenue.	**Utilities** • Invest in electricity generating facilities, power and potable water distribution networks, a new dam. • Increase efficiency and conservation of water, sewerage and electricity provision. **Construction** • Allow intra-industry competition to force up construction standards. **Transport** • Revise public transport policy to allow private participation alongside the subsidized public transport service. **Housing** • Promote home ownership financed by private capital. • Subsidize housing on a case by case basis to ensure social contiguity. • Apply financial discipline to government-run housing schemes. **Land Management** • Allocate land in a fair and transparent basis. **Environment** • Bring national environmental legislation into compliance with international best practices. • Raise public awareness of and contributions towards environmental protection. **Agriculture** • Focus on subsistence farming as well as on small to medium scale agricultural and livestock. • Ensure national food security and supply for a growing tourism sector.

Annex 9: Structuring terms of the Bond/Guarantee

Data Provided by White Oak, Seychelles Financial Advisors:

Seychelles discount rate profile						
30-Jun-10	30-Dec-10	30-Jun-11	30-Dec-11	30-Jun-12	30-Dec-12	30-Jun-13 Onwards
50.0%	45.0%	37.5%	25.0%	15.0%	12.5%	10.0%

Government of Seychelles

Bond Projections Worksheet: Assumptions

Figures in US$ million unless noted

Eligible Debt		
9.125% Eurobond due 2011	230	
Amortising Notes due 2011	79.8	309.8
Initial face value (euros)	54.8	
GoS payment, June 2008	1.1	
Exchange rate	1.5	
Loans	11.2	
Total Eligible Debt	**321.0**	

Face Value	
Par bonds (assumption)	50
Discount face value	135.5
Discount bonds	271.0
Discount writeoff	50.0%
Total Face Value at Issuance	**185.5**

Terms- Pars

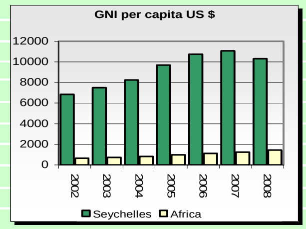
- Issuance date 30 December 2009
- 30 year average life
- Seven equal principal amortisations beginning June 2038
- Final maturity in June 2041
- 2% semiannual coupon to maturity

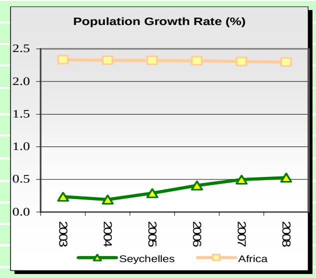
Terms-Discounts

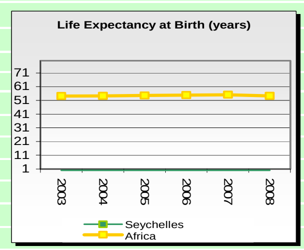
- Issuance date 30 December 2009
- 50% face value reduction
- 11.25 year average life
- 20 equal principal amortisations beginning June 2016
- Final maturity in December 2025
- Step up semiannual coupon: 3% for two years, 5% for three years, 7% for three years, 8% to maturity

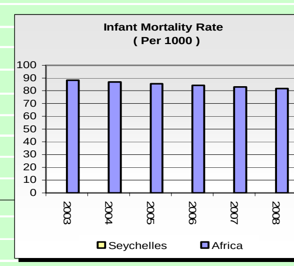
Annex 10: Seychelles Comparative Socioeconomic Indicators

	Year	Seychelles	Africa	Developing Countries	Developed Countries
Basic Indicators					
Area ('000 Km²)		0	30 323	80 976	54 658
Total Population (millions)	2008	0.1	986	5,523	1,229
Urban Population (% of Total)	2008	55.0	39.1	44.2	74.6
Population Density (per Km²)	2008	191.2	32.6	66.6	23.1
GNI per Capita (US $)	2008	10 290	1 428	2 405	38 579
Labor Force Participation - Total (%)	2008	46.5	42.3	45.6	54.6
Labor Force Participation - Female (%)	2008	46.2	41.1	39.7	44.9
Gender -Related Development Index Value	2005	...	0.482	0.694	0.911
Human Develop. Index (Rank among 174 countries)	2007	57	n.a.	n.a.	n.a.
Popul. Living Below $ 1 a Day (% of Population)	2005	...	34.3	25.0	...
Demographic Indicators					
Population Growth Rate - Total (%)	2008	0.5	2.3	1.4	0.3
Population Growth Rate - Urban (%)	2005	...	3.3	2.5	0.6
Population < 15 years (%)	2005	...	56.0	40.0	16.6
Population >= 65 years (%)	2005	...	4.5	3.3	15.6
Dependency Ratio (%)	2005	...	78.0	52.8	49,O
Sex Ratio (per 100 female)	2008	101.3	100.7	96.7	106.0
Female Population 15-49 years (% of total population)	2005	...	48.5	53.3	47.2
Life Expectancy at Birth - Total (years)	2005	...	54.5	65.7	77.1
Life Expectancy at Birth - Female (years)	2005	...	55.5	67.6	80.6
Crude Birth Rate (per 1,000)	2005	...	35.8	22.2	11.2
Crude Death Rate (per 1,000)	2005	...	12.4	8.1	10.1
Infant Mortality Rate (per 1,000)	2005	...	83.9	51.4	6.3
Child Mortality Rate (per 1,000)	2005	...	134.5	77.4	7.9
Total Fertility Rate (per woman)	2005	...	4.6	2.7	1.6
Maternal Mortality Rate (per 100,000)	2005	...	683.0	450.0	9.0
Women Using Contraception (%)	2005	...	29.7	61.0	75.0
Health & Nutrition Indicators					
Physicians (per 100,000 people)	2006	96.4	39.6	78.0	287.0
Nurses (per 100,000 people)*	2007	478.0	120.4	98.0	782.0
Births attended by Trained Health Personnel (%)	2006	99.7	51.2	59.0	99.0
Access to Safe Water (% of Population)	2004	88.0	68.0	62.0	100.0
Access to Health Services (% of Population)	2005	...	61.7	80.0	100.0
Access to Sanitation (% of Population)	2002	97.8	37.6	53.0	100.0
Percent. of Adults (aged 15-49) Living with HIV/AIDS	2005	...	4.5	1.3	0.3
Incidence of Tuberculosis (per 100,000)	2005	...	315.8	275.0	19.0
Child Immunization Against Tuberculosis (%)	2007	99.0	83.0	89.0	99.0
Child Immunization Against Measles (%)	2007	99.0	83.1	81.0	93.0
Underweight Children (% of children under 5 years)	2005	...	25.2	27.0	0.1
Daily Calorie Supply per Capita	2004	2 426	2 436	2 675	3 285
Public Expenditure on Health (as % of GDP)	2007	3.5	2.4	1.8	6.3
Education Indicators					
Gross Enrolment Ratio (%)					
Primary School - Total	2007	125.3	99.6	106.0	101.0
Primary School - Female	2007	124.6	92.1	103.0	101.0
Secondary School - Total	2007	111.8	43.5	60.0	101.5
Secondary School - Female	2007	119.1	40.8	58.0	101.0
Primary School Female Teaching Staff (% of Total)	2007	85.4	47.5	51.0	82.0
Adult Illiteracy Rate - Total (%)	2002	8.2	38.0	21.0	1.0
Adult Illiteracy Rate - Male (%)	2002	8.6	29.0	15.0	1.0
Adult Illiteracy Rate - Female (%)	2002	7.7	47.0	27.0	1.0
Percentage of GDP Spent on Education	2006	6.3	4.5	3.9	5.9
Environmental Indicators					
Land Use (Arable Land as % of Total Land Area)	2007	2.2	6.0	9.9	11.6
Annual Rate of Deforestation (%)	2005	...	0.7	0.4	-0.2
Annual Rate of Reforestation (%)	2005	...	10.9	...	...
Per Capita CO2 Emissions (metric tons)	2007	12.4	1.0	1.9	12.3







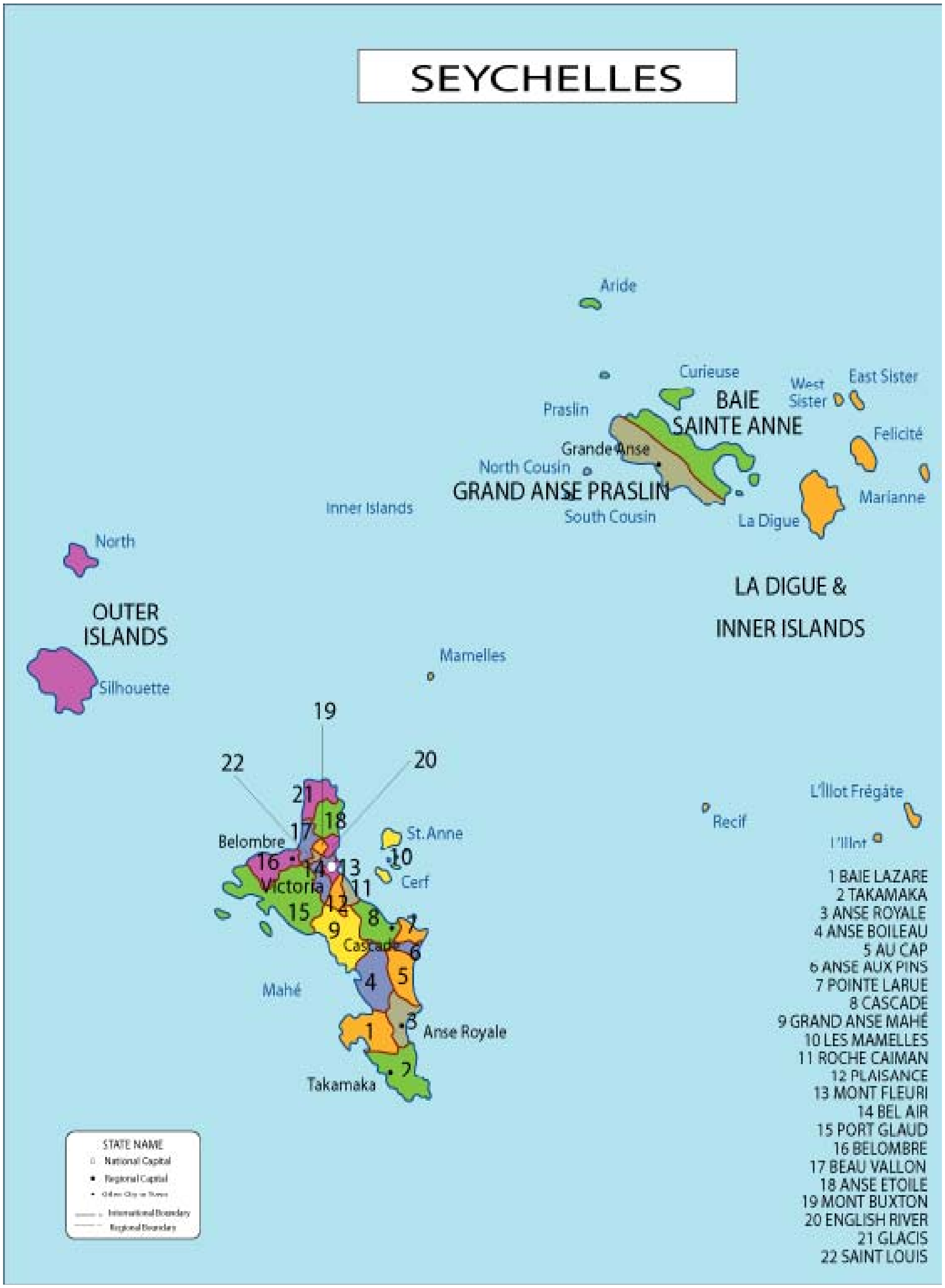


Sources : ADB Statistics Department Databases; World Bank: World Development Indicators; UNAIDS; UNSD; WHO, UNICEF, WRI, UNDP; Country Reports.

last update : October 2009

Note: n.a. : Not Applicable ; ... : Data Not Available

Annex 11: Map of Seychelles



Seychelles- Assessment letter for the African Development Bank
November 25, 2009

Macroeconomic performance of Seychelles under the Stand-by Arrangement (SBA) has been favorable and the reforms continue to be pursued with a high degree of ownership and broad public support. The liberalization of the exchange regime, a strong fiscal adjustment, and prudent monetary policies have contributed to restoring macroeconomic stability. Program implementation has been exemplary and talks to restructure public external debt are progressing well. A debt restructuring agreement with commercial creditors, on terms comparable to those agreed with Paris Club creditors, is a crucial element in reestablishing a sustainable public debt outlook and supporting economic recovery.

Recent Developments and Macroeconomic Outlook

Seychelles has made rapid progress in restoring macroeconomic stability. Inflation has been near zero since March and the exchange rate has appreciated steadily from lows early in the year. Official external reserves have recovered strongly from near depleted levels in mid-2008 to 1.3 months of imports at end October. Government expenditure has been tightly controlled and revenue has continued buoyant despite the difficult domestic and external environment.
The primary surplus reached 13.4 percent in the first nine months of the year.
The economy is responding favorably to the reforms and the contraction in economic activity will be somewhat less than previously forecast, with real GDP now expected to decline 7.5 percent in 2009. Recovering from the impact of the global recession, there are now early signs of a revival of business activity and employment creation. In 2010, economic growth is expected to rise to 4 percent as the economic recovery continues to strengthen.

Program Implementation

Program implementation has been exemplary, even in the face of strong head winds from the global recession. All end-September 2009 quantitative performance criteria were met with margins and all structural benchmarks under the SBA were implemented as scheduled, which provides a good basis for the completion of the third program review, scheduled for December 18, 2009.

The 2008 SBA addressed the foreign exchange distortions, implemented a large fiscal adjustment, and stabilized the macroeconomic environment, while taking first steps toward much-needed structural reform. With these objectives achieved, the focus now shifts to implementation of a second generation of reforms in a medium- term context. The key objectives are to consolidate macroeconomic stability, remove constraints to growth and improve the performance of the public sector. These objectives from the core of a new three-year arrangement with the IMF, under the Extended Fund Facility, which has been agreed, ad referendum , with Fund staff and is scheduled to be discussed by the Executive Board at the same time as the completion of the third SBA review in mid-December 2009. The reforms ahead aim to strengthen public financial management, institutionalize higher governance standards in the public enterprises, reform taxation, bolster the financial system, and improve the business environment

Progress in debt Restructuring

Good progress has been made in talks to restructure public external debt, which despite Seychelles' substantial adjustment efforts remains unsustainable. The authorities are continuing good faith efforts to reach agreement on comparable terms with all creditors, consistent with the fund's lending into arrears policy.

Following agreement with Paris Club creditors in April 2009, one non-Paris Club bilateral agreement has been signed and discussions with other creditors have advanced.
Consideration by the African Development Bank of the authorities' request for a US$ 10 million Policy-based Guarantee Operation would substantially increase chances of early success of the commercial debt restructuring, by lowering the risks for creditors . A commercial restructuring is a key component to the overall strategy of securing sustainable public debt and essential for economic recovery.