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Seychelles: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

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Second Review and
Financing Assurances
Review Under the
Extended
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The following item is a Letter of Intent of the government of Seychelles, which describes the policies that Seychelles intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Seychelles, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

SEYCHELLES: LETTER OF INTENT

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
December 3, 2010

Dear Mr. Strauss-Kahn:

1. The attached Memorandum of Economic and Financial Policies (MEFP) describes Seychelles' performance through September 2010, and updates the policies that were laid up in the MEFPs dated December 3, 2009 and June 1, 2010 for the remainder of 2010 and for 2011.
2. **We request completion of the second review under our Extended Arrangement (EFF), the release of the fifth tranche of SDR 1.76 million (20 percent of quota), rephrasing of disbursements and establishment of end-June 2011 and end-December 2011 performance criteria (PCs).** All the quantitative performance criteria at end-September 2010 were met. We remain committed to implement two reforms that are structural benchmarks for end-September 2010 and end-November 2010 respectively. The Customs Management Act was submitted in November 2010 to the National Assembly. We have initiated the work on the new Chart of Accounts and we plan to complete the work in the next 18 to 24 months with the assistance of the Fund.
3. **The EFF continues to accompany a comprehensive medium-term structural reform strategy** aimed at consolidating macroeconomic stability and securing growth; and to **guide our macroeconomic policies** over the next two years. **With the successful conclusion of our public debt restructuring** we have restored the prospect of debt sustainability.
4. **We believe that the economic and financial policies set forth in the MEFP are sufficient to ensure that the objectives of the program will continue to be met.** We stand ready to take any further measures that may prove necessary to meet our objectives. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. We remain committed to full implementation of the recommendations of the Fund's safeguards assessment of the Central Bank of Seychelles (CBS).
5. **It is expected that the third review of the arrangement under the EFF will be completed by end-March 2011, that the fourth review will be completed by end-September 2011, and that the fifth review will be completed by end-March 2012.** Financing assurances reviews will continue as long as public debt arrears remain outstanding.

6. **In line with our commitment to transparency, we request that the IMF publish this letter, the MEFP, the technical memorandum of understanding (TMU), and the staff report.** We will simultaneously publish these documents in Seychelles.

Sincerely yours,

/s/
Danny Faure
Minister of Finance and Vice President,
Republic of Seychelles

/s/
Pierre Laporte
Governor
Central Bank of Seychelles

ATTACHMENT 1

SEYCHELLES: SUPPLEMENTARY MEMORANDUM OF ECONOMIC, FINANCIAL AND STRUCTURAL REFORM POLICIES FOR 2010–11

I. INTRODUCTION

This document:

- Reviews macroeconomic and financial performance under our Extended Arrangement (EFF) arrangement through end-September 2010 and;
- Updates the MEFP of June 1st, 2010, detailing our policy commitment through December 2011.

II. MACROECONOMIC AND FINANCIAL CONTEXT AND SHORT TERM OUTLOOK

1. **Macroeconomic trends evolved favorably over 2010, exceeding expectations.** We have revised our GDP growth forecast for 2010 upwards from 4 percent to more than 6 percent, driven by higher than expected activity in the tourism, construction and manufacturing sectors. Tourism arrivals are projected to grow by around 10% in 2010, reflecting a resurgence in the sector after weakness immediately following the global financial crisis in 2008-09. As a result, the turnover in euro terms of the tourism sector is increasing, contrary to our initial projections at the start of the year. Local manufacturers have benefitted from increased domestic demand, resulting in higher levels of production, particularly in the first half of the year.

2. **Inflationary pressures remain contained despite monetary policy easing.** Inflation has been virtually flat over the course of the year, climbing at an average rate of 0.2 percent per month since April 2010. The 91-day T bill rate is around 1.5 percent, down from 4 percent at the start of the year. Private credit growth has gained momentum, rising by around 18 percent in the month ending September 2010 compared to December last year despite the slow decrease of banks' lending rates. After depreciating modestly against the US dollar earlier in the year, the rupee has remained stable over the past few months.

3. **With the rebound of growth, the external current account deficit is expected to widen in 2010.** Imports have been growing faster than exports reflecting the impact of stronger domestic demand as well as foreign direct investment (FDI) inflows and some large construction projects entirely financed from abroad. Foreign exchange reserves have continued to grow, reaching 2.2 months of imports in September.

III. PROGRAM IMPLEMENTATION

4. **All quantitative performance criteria at end-September were comfortably achieved (Table 2).** The government has exceeded its primary balance target by 2.4 percentage points of GDP. This has been driven primarily by higher revenues, reflecting stronger-than-expected

imports, higher business tax receipts and dividends from public enterprises. We introduced the new income tax regime in July this year, and increased the GST on tourism from 10 percent to 12 percent from November 1. The new personal income tax (PIT) introduced in July 2010 replaces the previous social security contributions and expands the tax base. The primary fiscal surplus for 2010 is now projected to be 9.4 percent of GDP, representing an over-performance of two percentage points of GDP compared with the program target. The reserve money and NIR targets have also been met with comfortable margins, while inflation remained low, reflecting appropriateness of the monetary policy stance.

5. **However, two structural benchmarks have been delayed.** The first is the new Customs Management Act which is expected to be submitted to the National Assembly in early December, 2010. The delay from September arose as a result of the capacity constraints in processing a 300-page piece of legislation. The second is the adoption of a new chart of accounts for the 2011 budget. Following discussions with IMF advisors, we agree that the scope of changes that could potentially be taken to upgrade our chart of accounts is considerably greater than originally anticipated. We are aiming to introduce a new version of the chart of accounts in the 2012 Budget. Other than these two measures, our ambitious structural reform agenda – focused on reducing the role of Government in the economy and improving the business environment – remains on track. The details of the measures are covered below, and our work with other development partners (World Bank, AfDB and EU) continues.

Medium Term Macro Framework

6. **The outlook for the economy is a continued recovery over the medium term, albeit at a slower rate than in 2010.** After rebounding strongly in 2010, we expect growth in the tourism sector to slow to single digits, consistent with the sluggish growth forecast for Europe (the source of most of our tourists). Similarly, growth in the construction sector will slow in 2011 following the completion of a major construction project that boosted growth in 2010. Nonetheless, we expect a real GDP growth in 2011 of 4.3 percent, rising to 5 percent in 2012-13. Inflation, after having been close to zero in 2010, is expected to revert to an average rate of 3 percent in 2011 and 2012. The current account deficit is expected to decline in 2011 and 2012, reflecting mostly lower FDI-related inflows and robust export growth. We continue to target an increase in gross international reserves to 3 months of imports by 2012, up from a projected 2.3 months at end-2010.

7. **Fiscal rebalancing remains on track.** With the maintenance of a substantial government budget primary surplus in 2011 and 2012, the stock of public debt will continue to decline, from 76 percent of GDP at end 2010 to around 65 percent at end- 2012; the bulk of the decline will come from a reduction in the domestic government debt. Beyond 2012 the Government plans to gradually reduce primary budget surpluses in line with our strategy to limit public debt to less than 50 percent of GDP by 2018.

8. **Despite our forecasts, we are mindful of the risks to our medium-term projections.** Downside risks include: a sluggish global economic recovery and a weak euro, which would dampen the number of tourists emanating from Europe; inadequate public infrastructure such as utilities and roads to support continued economic growth; and security risks associated with the threats to shipping routes from piracy. We are working hard to mitigate these risks, including through promoting Seychelles as a tourism destination outside Europe, stepped-up investment in and reforms of public utilities, and international cooperation to counter piracy disruptions.

Policies for 2011

9. **The major objectives of our EFF-supported program remain to:**

- consolidate macroeconomic stability;
- improve economic efficiency and durably raise growth through the implementation of a second generation of structural reforms; and
- maintain a path of debt reduction consistent with external sustainability.

The policies we will pursue in 2011 to achieve these objectives are outlined below.

A. Fiscal Policy

10. **The 2011 budget aims at achieving a primary surplus of 5 percent of GDP.** This target is lower than the original target under the EFF supported program of 6 percent of GDP, but remains consistent with the medium-term debt and fiscal sustainability targets. The Government's strong fiscal performance in 2010 has created the fiscal space for additional spending, in particular on priority infrastructure investment and social expenditure.

11. **Growth in government revenue in 2011 reflects mostly accounting changes, including the consolidation of government entities in the budget and one-off factors affecting 2010.** Abstracting from budget presentation changes (which increase revenue by 2.2 percentage points of GDP), the government revenue to GDP ratio will decline by 1.5 percent as the 2011 Budget estimates are adjusted to reflect one-off factors affecting 2010 (such as exceptionally high business tax rates and payments from Nouvobanq and the renegotiated shareholders agreement of the tuna cannery). The changes are accounted for in the table below. Policy changes (in GST and Income Tax) are aimed at further rationalizing the tax system and harmonizing rates between sectors, they represent an increase of 0.4 percent of GDP.

12. **Current primary expenditure is expected to rise as the Government implements wage reforms and some recruitment for priority sectors.** Abstracting from classification changes (2.0 percentage points of GDP), the net increase is equivalent to 0.8 percent of GDP. The key drivers of expenditure increase are outlined in the table below.

Impact of 2011/2010 Projected Changes in Government Revenues and Grants (% of GDP)		
Tax Policy Changes	Description	+0.4
GST in Tourism	Increase in GST rate from 10 percent to 12 percent	+0.6
Income Tax	Reduction in PIT rate from 18.75 percent to 15 percent (in October 2010) Harmonization of rates across all employees from January 2011	-0.4 +0.2
Reclassification	Description	+2.0
Grossing up of Wages	Government employee PIT contributions counted as revenue	+1.1
Pension Fund	Contributions from employers and employees consolidated into Budget and incorporation of dividends and interests from Pension Fund investments	+0.6
Contributions to SFA	License fees and other contributions from EU	+0.1
Budget dependent entities	Incorporation of entities revenue sources into 2011 budget	+0.3
Other Changes	Description	-1.4
o.w. Business Tax	Downward revision of projected business tax income after exceptionally high levels in 2010 following revaluation gains in the banking sector after the float of the rupee	-0.6
o.w. Dividends	Changes to dividend income including the combination of exceptionally high Nuovobanq dividends and one-off payments from the IOT renegotiated shareholders agreement in 2010 and projected SEYPEC dividends in 2011	-0.3
Change in government revenues:		+1.0
Grants	Increase in grants projected for 2011 due to delay in timing of disbursements in 2010 (including EU budget support and UAE in-kind benefits for coastguard)	+2.5
Impact of overall change in government revenues:		+3.5
Impact of 2011/2010 Projected Changes in Government Primary Expenditure and Net Lending (% of GDP)		
Reclassification	Description	+2.0
Grossing up of Wages	Government employee contributions counted as expenditure	+1.0
Pension Fund	Benefits consolidated in the budget	+0.6
Reclassification of several budget-dependent entities	Inclusion of all expenditures of budget-dependent agencies in line with budget re-classification policy	+0.4
Other Changes	Description	+2.4
o.w. Scheme of Service	Full-year effect in education and health and new schemes for immigration, social affairs, finance, police, and defence	+0.3
o.w. Recruitment	Priority areas only	+0.4
o.w. Budget Entities	Higher spending by certain budget-dependent agencies such the Land Transport Agency (on roads), the Tourism Board and the National Sports Council.	+0.6
o.w. Capital expenditures	Priority infrastructure projects such as investment in public utilities and rehabilitation of the Victoria hospital	+2.0
Change in government primary expenditure:		+4.4
Net Lending	No net repayment projected in 2011 Budget since Government loan to state-owned oil company was fully reimbursed in 2010.	-(-3.4)
Impact of overall change in government primary expenditure:		+7.8
Overall Impact on the Primary Balance:		-4.4

13. **Capital expenditures will continue to be directed to priority areas to support continued economic growth.** In percentage of GDP, capital expenditures will rise by 1.5 percent in 2011. This includes some large foreign-financed projects, such as a new coast guard facility and landfill. Capital grants to the Public Utilities Company will amount to 1.5 percentage points of GDP. Other key projects include the rehabilitation of the main Victoria hospital, and of education facilities, and the pursuit of an important housing project in Perseverance Island, that also benefits from important external financing.

14. We will establish a contingency reserve of SR 50 million in the 2011 budget. We plan to release this reserve for capital investments by a number of ministries, starting in July 2011, provided that the revenue targets for June 2011 are met.

B. Tax Reform

15. **The reform of the tax system launched at the start of 2010 continues.** The base has been broadened, and the system is becoming increasingly simple, fair and equitable as the various stages of reform come into effect, with no new tax incentives and exemptions. From January 1, 2011 with the increase in the personal income tax rate paid by expatriates, there will be one harmonized rate of personal income tax for all employees in all sectors.

16. **The final major tax scheduled for introduction is the Value Added Tax (VAT).** The introduction of the VAT is aimed at improving integration in the economy, broadening of the base, elimination of cascading, and increased efficiency and fairness. We have already started discussions with a number of stakeholders – including the Chamber of Commerce, retailers association and civil society organizations – to ensure that the legislative framework is a practical one, understood by both users and administrators. The legislation work is advanced, and we aim to present the bill to the National Assembly by end-December 2010. This will give us 18 months to carry out an extensive education campaign for the population; recruit new staff; install necessary infrastructure; and ensure that the staff of the Seychelles Revenue Commission (SRC) are sufficiently equipped for the introduction of the VAT. The VAT regulations including rates, thresholds and exemptions will be submitted for approval by Cabinet by end-June 2011.

17. **In addition, we are pursuing further reforms to the administration of the tax system.** The improvement of the SRC governance continues, with the creation of a Large Taxpayer Unit already complete. The newly created unit will segregate its staff to particular sectors to ensure better understanding of sector-trends, allowing for more targeted use of the Audit Team. We will also pursue the simplification of the various systems for identifying taxpayers and greater cooperation between customers and SRC to monitor the consistency of compliance with VAT and customs taxation.

C. Public Financial Management

18. **Our progress in strengthening public financial management continues, in line with Fund recommendations.** The revised Budget Classification policy for public entities will be fully implemented by the end of 2010. Under this system, budget-dependent public bodies are classified into three groups: (1) providers of specialized services that are core to the running of the country; (2) regulatory authorities; and (3) providers of commercial services essential to the socio-economic development of the country. The classification policy sets out the operational and budget arrangements for each group, and has resulted in most entities in groups 1 and 2 being included in the budget documents. The information generated by this enhanced budget reporting will facilitate assessments of the commercialization and privatization of certain public entities, in line with our broader strategy of reducing the role of the state in the economy.

19. **To assess the progress already made and identify the next steps,** we will undertake a new assessment of the government's financial operations under the EU's Public Expenditure and Financial Accountability (PEFA) standards in early 2011 with the assistance of the European Union.

20. **We will update our Chart of Accounts to support improved decision-making on the allocation of resources.** We will establish a cross-agency committee in January 2011 which will identify our key needs and possible reforms, with the assistance of the IMF. A plan of action will be submitted to the Cabinet of Ministers before end of April 2011 with the aim of introducing the new Chart of Accounts in the 2012 Budget. We will also review the Accounting Standards of Financial Statement to ensure it is consistent with International Public Sector Accounting Standards (IPSAS), by September 2011.

21. **We continue to invest in the capacity of Government officials to oversee and contribute to public financial management.** We are providing budget management training for departmental budget officers and will revise the Financial Instructions and Accounting Manual by June 2011. Within the Ministry of Finance we are building capacity to analyze capital expenditure proposals, which will facilitate improved allocation of our capital expenditure budget.

22. **Our fiscal policy objectives will be supported by strengthened budget processes.** The main changes from the 2010 Budget process, which have been put in place since the last MEFP are:

- a. Our 2011 Budget has moved to a medium-term budgeting framework, *presenting the government's fiscal and economic projections over a three-year horizon.*
- b. The 2011 budget process commenced in June 2010 with Cabinet's discussion of the *Budget Strategy and Outlook (BSO) document*, which set the fiscal context and established the government's priorities.
- c. *All ministries and budget dependent entities used a standard template* to submit their recurrent and capital expenditure proposals to the Ministry of Finance

providing detailed costing. The Ministry of Finance's capacity to scrutinize these expenditure proposals has been enhanced through increased resources.

- d. *Mid-year formal expenditure reviews were carried out*, with detailed reconciliation of budget estimates with quarterly and year-end outcomes.
- e. In parallel, our *macroeconomic and revenue forecasting capacity has been enhanced* through the establishment of a dedicated branch within the Ministry of Finance, which is now fully operational.

23. **Further improvements will be made through amendments to our Public Finance Bill.** These amendments will seek to reflect recent operational improvements in public financial management in the legal framework, introducing principles such as transparency, accountability, medium-term stability and budget performance into the Bill and extending its coverage to budget formulation and budget execution processes, in line with Fund recommendations. The law would also extend the National Assembly's oversight of the budget to include the capital expenditure budget, in addition to current expenditures. Given the complexity and significance of this reform we will seek further Fund advice on developing and implementing the legislation. The Public Finance Bill will be submitted to Cabinet for approval by the end of September 2011.

24. **We are improving the management and operation of the Pension Fund and the Social Security Fund.** As the first step toward achieving actuarial equilibrium in the Pension Fund, we are modifying the contribution system for all employees from January 1, 2011. Instead of a fixed contribution paid by the employee and the employer, the contribution will become a fixed *percentage* of the employee's salary, payable by both parties. The rate will be 1.0 percent for 2011 and move to 1.5 percent from January 2012. On the Social Security Fund, the Social Security Act was passed in July, and the Government has appointed a Board of Trustees under the new Act in order to ensure professional and independent management of its assets. Going forward, a policy will be formulated outlining the investment objectives of these assets by September 2011, using the recommendations of the recent report of the World Bank.

D. Public Enterprise Reform

Non-Financial Institutions

25. **Our commitment to improving our capacity to invest in public infrastructure has not abated, particularly regarding the urgent needs in the utilities sector.** We are in negotiations with BADEA regarding the sourcing of an expert to carry out the study on the tariffs of the Public Utilities Company (PUC) planned for the first half of 2011. The government's objective is to improve the quality of service provision in the utilities sector, which over the long-term will require PUC to implement a tariff policy that is consistent with full cost recovery and meeting future investment needs. We will complete a study on the optimal structure and levels of tariffs by end-July 2011. In addition, we will implement tariff adjustments to fuel price variations after September 2011.

26. The government is pursuing a public enterprise reform strategy aimed at achieving greater efficiency, transparency and accountability.

- a. Following the introduction of the Public Enterprise Monitoring and Control Act in late 2009, the Public and Financial Accounts Committee has started its monitoring work, including through hearings of the management of several public enterprises. The Committee, established by the Act to enhance governance, comprises members of the National Assembly, and has access to the audited accounts of the public enterprises.
- b. The bulk of the recommendations made by the management audits of the public entities have been put in force, resulting in improved governance standards of these entities. The Public Enterprise Monitoring Division (PEMD) will also present a policy paper to Cabinet recommending a set of procedures for the selection criteria for Board members in the first quarter of 2011.
- c. A report following a strategic assessment of the national airline has been submitted by the international aviation consultants who conducted their work in the latter half of this year. The airline has recently presented its reply to these recommendations to Cabinet, which is considering its response.
- d. Since the last MEFP, the new Postal Sector Act has come into force which establishes the postal service as a fully independent commercial entity, outside of the Government budget.
- e. Following the implementation of the new Budget Reclassification policy, we will develop a privatization plan for non-strategic public enterprises which do not serve public policy goals by the end of September 2011.

Financial Institutions

27. The government, together with the CBS, is strengthening the management and oversight of public financial institutions and assessing the case for continued state ownership.

- a. The financial audit of the Housing Finance Corporation has been completed, and the recommendations submitted to the CBS. In addition, by June 2011, we will submit for Cabinet's adoption, an action plan for house financing policy that limits the role of the public sector, drawing on the recommendations of the FIRST Initiative's report.
- b. It is government's policy to privatize Nouvobanq in the context of our medium-term strategy. The IFC is scheduled to conduct an evaluation of the state-owned banks in December 2010 and make recommendations regarding the feasibility of their privatization shortly thereafter. The Government is expected to respond to these recommendations and formulate a privatization strategy by the end of June 2011. We recognize that, in the longer term, privatization of the two publicly-owned deposit taking institutions – Seychelles Savings Bank and Nouvobanq - could bring new technology, strengthen management and fresh capital to our banking system, stimulate competition and enhance the quality of

bank services. In the near-term, however, both institutions are performing well financially, present limited risk to the government's balance sheet and are playing a leading role in promoting financial intermediation and credit creation.

E. Monetary and Financial Sector Policies

Monetary and Exchange Rate Policies

28. **The Central Bank of Seychelles (CBS) will continue to rely on reserve money targeting as its monetary policy framework.** In the short to medium term CBS will continue to use Repos as the main instrument to guide short-term interest rates while Deposit Auction Arrangement (DAA) and Credit Auction Arrangement (CAA), and foreign exchange Swaps will be used for fine tuning. The Bank will continue to increase its range of monetary instruments to allow it to achieve greater flexibility in its market interventions.

29. **The CBS and the Ministry of Finance (MOF) will seek to enhance the effectiveness of liquidity management to ensure the effectiveness of monetary policy framework and to contribute to financial sector deepening.** In the context of its liquidity forecasting and reserve money programming framework, the CBS and MOF will continue to work closely on the T-bill issuance profile to promote the smooth functioning of the market and provide for the development of a benchmark yield curve. A calendar of weekly T-bill issuance is communicated four weeks in advance in order to inform the market of the quantity of paper to be issued. This has helped improve the predictability of the securities market and has helped banks in better managing their liquidity.

30. **The reduction in Government's domestic debt poses a major challenge for monetary policy.** A reduction in the issuance of treasury bills as the Government continues to retire its domestic debt has resulted in a marked increase in commercial bank liquidity. The CBS will work in tandem with the Ministry of Finance to devise a strategy for dealing with this situation to ensure that the objective of debt reduction does not compromise the effectiveness of the transmission mechanism of monetary policy and the development of the financial system. Specifically, should liquidity persist, the MoF stands ready to issue up to SR 250 million of T-bills for monetary policy purposes, to help the CBS absorb at least part of excess liquidity and thereby share the burden of sterilization costs.

31. **We remain committed to a floating exchange rate regime, which has served Seychelles well since the beginning of the economic reforms.** The CBS will maintain its policy of intervening in the foreign exchange market only to smooth out excessive volatility and ensure orderly market conditions. The CBS will continue to work closely with banks and make use of technical assistance from the IMF and other institutions to improve the efficiency of the inter-bank market. In this context we are working on a code of conduct which will guide all participants in the foreign exchange as well as in the money market.

32. **The implementation of an integrated (core) banking system is on course to go live on December 01, 2010.** This project will assist the CBS in improving the efficiency of its operations and significantly mitigate risks associated with having a multitude of software.

33. **The recapitalization of the CBS has progressed well.** The Government made two rounds of capital injection for R63 million each through treasury bills in June and September 2010, and a final injection of R62 million is planned in December. This will boost CBS' capitalization level to 10 percent of monetary liabilities by the end of the year, as per the requirements of the CBS Act, as amended in 2009. This will strengthen the balance sheet of the CBS and enhance its portfolio of tradable securities to be used in open market operations.

34. **As external reserves continue to accumulate, the CBS will need to continue to strengthen its reserve management activities.** Given its internal capacity constraints, the CBS has taken a prudent approach to its reserve management program, limiting the use of external parties to manage its reserve asset to the World Bank through its Reserve Advisory and Management Program (RAMP), the Asset Management services of the Bank for International Settlement (BIS), and the Crown Agent, which also has a long standing reputation of working with central banks. Discussions with all three institutions are at an advanced stage and CBS expects to enter into formal arrangements with them in early 2011. Besides their more favorable terms in investing a portion of CBS' external reserves, these institutions will also provide technical assistance in the area of capacity building and training of CBS internal managers to better equip CBS staff in management of reserves.

35. **The CBS continues to make good progress in modernizing the national payment system.** Several important steps were taken in 2009 and continue in 2010, including: (i) establishment of a complete requirements and standards document for electronic funds transfers that replaced the manual settlement system; (ii) adoption of the new cheque standard documents in July 2009; (iii) formalization of the new clearing house rules in April 2010; and (iv) introduction of the National Clearing and Settlement system Act in July 2010. This legislation provides a formal legal base for the National Payment Systems and creates it as a legal entity. Furthermore it will provide a clear mandate for the undertaking of the payment systems oversight, entry and participation criteria, recognition and supervision of systems for clearance and settlement. Following the implementation of the Core Banking System, the new platform will facilitate the introduction of new payment systems such as an Electronic Clearing House and the introduction of a local rupee Switching System to facilitate the settlement of local ATM/POS transactions. Additionally, the CBS will continue to promote the use of electronic funds transfer and the use of plastic card, as well as implement a real time gross settlement system in 2011/2012.

36. **The CBS has embarked on an exercise to introduce a formal risk management framework.** In May 2010 a full risk assessment of the CBS was conducted at its own initiative, by a reputable international audit firm. The draft reports of this evaluation along with a draft risk policy and necessary tools to implement a robust strategic risk framework have been submitted to CBS for comments. The CBS has set up a risk implementation committee (RIC) to drive the risk framework by addressing the risks identified and taking responsibility of ongoing risk

assessments through Division Heads and risk monitoring through the Internal Audit Division (IAD). This risk assessment and its findings will also allow the CBS to adopt a risk-based internal audit framework in line with the recommendations of the latest Safeguards Assessment report. This will induce a training plan to support the new internal audit and risk oversight functions of CBS.

37. **CBS has completed its business continuity plan (BCP), ahead of the planned deadline of end-2010.** The BCP was prepared by a reputable international consulting firm in close consultation with CBS staff. An action plan has been submitted to the CBS Management and this will act as the roadmap for implement of this plan.

Financial Sector Reforms

38. **Substantial progress has been made in developing a risk-based supervision framework, with IMF technical assistance.** The CBS Board recently fully approved the CAMELS¹ bank rating system, and it has already been fully adopted in a recent onsite examination of a commercial bank. Frequent examinations are being conducted as per the procedural manuals on each component of the bank rating system. In the context of this risk-based approach the CBS will require banks to submit business plans on an annual basis by end-2011. This will allow the supervision staff to enhance micro-prudential supervision of financial institutions and beef up staff capacity in terms of analysis of these business plans on an ongoing basis. The CBS is also working toward further developing the CAELS² approach to offsite supervision as well as the enhancement of macroprudential supervision. In addition minimum capital for banks has been doubled, with a three year transition period granted to existing banks which do not meet the new requirement.

39. **The CBS continues to be proactive in its effort to safeguard financial sector stability.** At the request of CBS, the Toronto Centre carried out a four day workshop to a team of Central Bank, Ministry of Finance and Seychelles International Business Authority staff on crisis preparedness in October 2010. This has initiated work on Seychelles' crisis binder which contains tabs on, *inter alia* communication and co-ordination strategies, resolution options and challenges which may impede effective resolution of a crisis. An action plan will be devised to address gaps which have been identified during the exercise. The first draft of the crisis binder will be submitted to Toronto Centre for its review.

40. **Seychelles will continue its efforts to promote transparency in the offshore financial sector** through strengthened supervision by CBS in coordination with the Seychelles

¹ Acronym for **C**-Capital Adequacy, **A**-Asset Quality, **M**-Management, **E**-Earnings Performance, **L**-Liquidity and **S**-Sensitivity to Market Risk.

² Acronym for **C**-Capital Adequacy, **A**-Asset Quality, **E**-Earnings Performance, **L**-Liquidity and **S**-Sensitivity to Market Risk.

International Business Authority, and the Financial Intelligence Unit. To that effect, further to a review which has been conducted by the Global Forum on Transparency and Exchange of Information for Tax Purposes, Seychelles has expressed to the organization its commitment to ascertain that the country's legal framework supports and upholds the principle of transparency and exchange of information.

41. **We are committed to encouraging a sound and efficient insurance sector that promotes policyholder confidence.** The FIRST Initiative has agreed to give technical assistance to CBS to strengthen insurance supervision. A mission is slated for December 2010 and will include a review of the regulatory framework and preparation of manuals for conducting examination of insurance and insurance-related companies.

42. **CBS will continue to strengthen supervision of banks and other non-bank financial institutions under its supervisory ambit.** New regulations on Capital Adequacy and Credit Classification and Provisioning have been formally adopted in November 2010. These regulations ensure conformity with international best practices, including provisioning standards as per international norms and certain components of Basel II.

43. **In line with its new mandate the CBS has already begun supervising the Housing Finance Company (HFC) and the Development Bank of Seychelles (DBS).** The CBS will use the results of the recent special audits by external auditors of HFC and DBS as a basis to begin its supervision of the institutions on a risk-based approach, which will include offsite as well as onsite examinations of these institutions. Moreover the recent strategic assessment of these same institutions by the FIRST Initiative will allow the Government to make a more fundamental decision on the future of these institutions.

44. **CBS will make increasing use of stress testing in its effort to evaluate the safety and soundness of institutions under its supervision.** To that effect the recently conducted stress test devised by the MCM expert will be used as benchmark. The stress test results will guide the CBS examiners to target specific areas of concern.

45. **The banking system currently suffers from a lack of competition that is hampering credit growth and the development of the banking sector.** Existing barriers to credit development include excessive prepayment penalties, long delays in registering guarantees and collateral, as well as excessively long periods for the court system to liquidate the collaterals. Moreover, the absence of a credit rating system and limited disclosures by banks under the Financial Institutions Act (FIA) prevent adequate assessments of potential clients' creditworthiness. In light of these constraints the CBS is carrying out a study to identify current uncompetitive practices and barriers, and based on the results it will draw up an action plan to address these shortcomings. Some of these measures will require an amendment of the FIA, which is planned for end-April 2011.

46. **The CBS is committed to promoting fair competition in the financial sector to ensure consumer protection and maintain a healthy and competitive financial system.** In that respect the CBS will work in close liaison with the Fair Trading Commission and the

Seychelles Bankers Association to achieve this goal. The initial step is to launch a public awareness campaign on different financial products. CBS will also review its requirements for disclosure of banks' fees and charges to ensure greater transparency toward the public.

Devise action plan to address gaps identified in crisis preparedness exercise	December 2010
Amend CBS Act to strengthen CBS independence and improve internal control as per safeguard assessment recommendations	March 2011
Finalization of Seychelles' crisis binder	March 2011
Submit FIA amendments to Cabinet of Ministers	April 2011
Require banks to submit business plans	December 2011
Review regulatory framework of insurance sector, preparation of manuals for insurance supervision	December 2011
Conduct onsite examinations of DBS and HFC	December 2011

F. Balance of Payments

External Debt Restructuring

47. **We are making headway in normalizing relations with those remaining external creditors with whom restructuring agreements had yet to be concluded at the time the last MEFP was prepared.** As of end-November, restructuring agreements covering approximately US\$631million, or around 91 percent of the debt eligible for restructuring have been reached. In aggregate, these agreements have cancelled approximately US\$310 million in principal, accrued interest, and other charges. The remaining balances have by and large been rescheduled over periods exceeding 17 years at low rates of interest, with the bulk of the foreign currency debt owed to local commercial banks converted into rupees.

48. **The entirety of foreign currency debts owed to locally-based commercial banks has now been successfully restructured.** In total, agreements covering nine facilities outstanding to local and local affiliates of foreign banks have been concluded. Two of these facilities were bought back at a steep discount. Almost all of the remaining claims have been converted into rupees at market rates, and rescheduled over the long term, often for periods exceeding 30 years. Material grace periods on principal apply to all. Floating interest rates have been agreed in most cases, at modest fixed margins over six-month or one-year treasury bills. The Government has also concluded, or is in the process of concluding, eight of the 11 bilateral agreements that implement the April 2009 Paris Club agreement. Another is in the advanced

stages of negotiation. We expect to receive the two remaining draft agreements from creditors shortly.

49. **The Government will persevere with its efforts to conclude restructuring agreements on comparable terms with the few remaining commercial bank and non-Paris Club official bilateral creditors holding unresolved claims.** In principle agreements have been reached with all non-Paris Club official bilateral creditors holding unresolved claims, and implementation is expected over the course of the fourth quarter of 2010. In principle agreements have also been reached with the two remaining commercial bank creditors, both of which are foreign institutions. The smaller of these two claims is the uninsured portion of an export credit officially supported by a non-Paris Club official bilateral creditor that has already agreed to restructure its claim on Paris Club terms.

Trade Policies

50. **We remain committed to a liberal foreign trade policy.** Our import tariff regime is already highly liberal, with more than 94% of all tariff lines set at zero. Nonetheless, we are undertaking measures to modernize our trade regime to bring it into conformity with our regional, bilateral and international trade obligations. We remain committed to the WTO accession process, which we are pursuing as a priority.

51. **We are pursuing trade negotiations with the European Union.** We have signed in August 2009 with the EU an interim European Partnership Agreement (EPA) together with Comoros, Madagascar, Mauritius, Zambia and Zimbabwe. The agreement ensures that our exports into the EU are not subject to duties or quota. In exchange, we will gradually phase out the maximum duty rates applicable to 98 percent of our imports from the EU.

G. National Statistics

52. **We remain strongly committed to improving the quality, periodicity, and timeliness of macroeconomic and financial statistics.** A new National Statistics Act (NSA) was approved by the National Assembly in July 2010, creating the National Bureau of Statistics (NBS), reinforcing its independence and strengthening its mandate to collect data compared to its predecessor (NSB). The governing Board, which is independent of government, comprises members from organizations (both public and private) that are directly affecting and/or affected by the NBS statistics. The Bureau has seen its current budget increased in a bid to increase capacity building.

53. **We are moving to address deficiencies in key macroeconomic data – especially GDP estimates and external sector statistics – to improve their usefulness for economic analysis and policy formulation.** To this effect, a strategic plan will be adopted by end-February 2011 which will map out our path toward SDDS and IIP6 compliance. The IMF sent a mission to work on quarterly National Accounts in November 2010, and another to assist with the development of an Industrial Index and Producer Price Index to bring us in line with international best practice, and implementation of the IMF's Special Data Dissemination Standard (SDDS). We aim to submit an advance release calendar for SDDS compliance by mid-

2012. We will increase co-ordination across government agencies to improve quality and consistency in the FDI statistics. The Ministry of Employment will reinforce its efforts to produce high-frequency labor market data. We have requested further technical assistance from the Fund (on fiscal and national accounts) and the World Bank (to strengthen the management and operations of the NSB).

IV. PROGRAM MONITORING

54. **The EFF-supported program will be monitored by semi-annual program reviews, with semi-annual quantitative performance criteria and disbursements.** We propose to move to a new program review schedule to better synchronize with our budget cycle, with the new test dates being December and June. The semi-annual quantitative performance criteria (QPCs) for 2011 are shown in Table 2. The structural benchmarks for 2011 are shown in Table 3.

55. **The attached Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria, indicative targets and adjusters under the program.** Seychelles will avoid introducing new exchange restrictions, multiple currency practices, or bilateral payments agreements in contradiction with Article VIII of the IMF's Articles of Agreement and imposing any import restrictions for balance of payments reasons. We stand ready to adopt any additional measures, in consultation with IMF staff, which may become necessary to ensure program success.

Table 1: Structural Benchmarks, 2010-2011

Measure	Target date	Macroeconomic rationale
Submit VAT bill to National Assembly, to become effective July 1, 2012 (MEFP ¶16)	End-December 2010	To modernize the tax system and remove tax distortions.
Cabinet approval of the amendments to financial institutions' act as described in MEFP ¶45	End-April 2011	To strengthen competition in the banking sector and improve risk management
Adopt an action plan for house financing policy that limits the role of the public sector (MEFP ¶27)	End-June 2011	To reduce fiscal risks, strengthen competition and promote development of the banking system
Launch a strategic plan for the reform of the social security system (MEFP ¶24)	End-June 2011	To establish well-targeted and sustainable social security system
Cabinet approval of VAT regulations, including rates, exemptions and thresholds (MEFP ¶16)	End-June 2011	To modernize the tax system and remove tax distortions
Commission and complete a study on optimal tariffs for utilities (MEFP ¶25)	End-July 2011	To ensure cost recovery and long-term sustainability of utilities
Develop a privatization plan for non-strategic public enterprises, which do not serve public policy goals (MEFP ¶26)	End-September 2011	To reduce the role of the state in the economy, improve corporate governance and minimize fiscal risks
Cabinet approval of a new Public Finance bill extending the National Assembly's oversight on capital expenditure budget. (MEFP ¶23)	End-September 2011	To strengthen public finance management
Reinstate the electricity tariff adjustment for fuel price variation (MEFP ¶25)	End-September 2011	To reduce losses of the public utility company

Table 2. Seychelles: Quantitative Performance Criteria Under the EFF, December 2010–December 2011
(Millions of Seychelles rupees; end-of-period)

	2010		2011		
	December	March	June	September	December
	Program	Indicative target	Performance Criteria	Indicative target	Performance Criteria
Performance criteria					
Net international reserves of the CBS, millions of U.S. dollars (floor) ¹	168	189	192	202	213
Reserve money (ceiling)	1,753	1,804	1,824	1,844	1,862
Primary balance of the consolidated government (cumulative floor) ^{2, 3}	823	142	240	515	602
The contracting or guaranteeing of new external debt by the public sector (Millions of U.S. dollars; cumulative ceiling) ²	37	4	33	46	47
The contracting or guaranteeing of new short-term external debt by the public sector (Millions of U.S. dollars; cumulative ceiling) ²	0.0	0.0	0.0	0.0	0.0
The accumulation of external payments arrears by the public sector (ceiling) ³	0.0	0.0	0.0	0.0	0.0
The accumulation of domestic payment arrears by the public sector (ceiling)	0.0	0.0	0.0	0.0	0.0
Memorandum items:					
External non project financing (millions of U.S. dollars; cumulative) ²	31.8	-1.4	0.0	2.1	5.5
Program financing support	19.6	0.0	0.0	0.0	0.0
Cash payments on foreign debt service	9.2	6.5	9.3	11.7	15.8
External budget grants	21.4	5.1	9.3	13.8	21.3
Program accounting exchange rates					
SR/US\$ (end-of-quarter)	11.75	12.30	12.30	12.30	12.30
US\$/Euro (end-of-quarter)	1.27	1.36	1.36	1.36	1.36
US\$/UK pound (end-of-quarter)	1.48	1.57	1.57	1.57	1.57
US\$/SDR (end-of-quarter)	1.49	1.56	1.56	1.56	1.56

Sources: Seychelles authorities and IMF staff estimates and projections.

¹ The floor will be adjusted downward (upward) for any shortfall (excess) in external nonproject financial support from that assumed in the program.

² Cumulative flows from the beginning of the calendar year.

³ The nonaccumulation of new external payment arrears constitutes a continuous performance criterion. Excludes arrears for which a rescheduling agreement is sought.

ATTACHMENT 2**SEYCHELLES: TECHNICAL MEMORANDUM OF UNDERSTANDING**

1. This technical memorandum of understanding presents the definitions of variables included in the quantitative performance criteria and indicative targets set out in the memorandum of economic and financial policies (MEFP), the key assumptions, and the reporting requirements of the Government and the Central Bank of Seychelles (CBS) needed to adequately monitor economic and financial developments. The quantitative performance criteria and indicative targets, and the benchmarks for 2010-11 are listed in Tables 1 and 3 of the MEFP, respectively.

I. I. QUANTITATIVE PERFORMANCE CRITERIA**A. Net International Reserves of the CBS (Floor)****Definition**

2. Net international reserves (NIR) of the CBS are defined for program monitoring purposes as reserve assets of the CBS, minus reserve liabilities of the CBS (including liabilities to the IMF). Reserve assets of the CBS are claims on nonresidents that are readily available (i.e., liquid and marketable assets, free of any pledges or encumbrances and excluding project balances and blocked or escrow accounts, and bank reserves in foreign currency maintained for the purpose of meeting the reserve requirements), controlled by the CBS, and held for the purpose of intervening in foreign exchange markets. They include holdings of SDRs, holdings of foreign exchange, demand and short-term deposits at foreign banks abroad, fixed-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities. Reserve liabilities of the CBS comprise liabilities to nonresidents contracted by the CBS, any net off-balance-sheet position of the CBS (futures, forwards, swaps, or options) with either residents or nonresidents, including those to the IMF.

Calculation method

3. For program monitoring purposes, reserves assets and liabilities at each test date, must be converted into U.S. dollars using the end of period exchange rates assumed in the program.

II. MONITORING AND REPORTING

4. At each program test date, the quarterly net international reserves data submitted by the CBS to the IMF will be audited by the CBS external auditors in accordance with International Standards on Auditing, to ensure conformity with the program definition and calculation methods. Reports will be submitted to the CBS, with a copy to the IMF, no later than two months after each test date.

Adjusters

5. The floor on the CBS's NIR will be adjusted upward (downward) by the amount by which the external non-project loans and cash grants exceeds (falls short of) the amounts assumed in the program (MEFP Table 1). The floors will also be adjusted upwards (downwards) by the amount that external debt service payments fall short (exceed) the amounts assumed in the program.

B. Reserve Money (Ceiling)

Definition

6. Reserve money is equivalent to currency issued and deposits held by financial institutions at the central bank (bank reserves), including those denominated in foreign currencies. Evaluation of performance of reserve money with respect to the program ceiling will be done at the program accounting exchange rate.

Monitoring and reporting

7. For each program test date, the quarterly reserve money data submitted by the CBS to the IMF will be audited by the CBS' external auditors in accordance with International Standards on Auditing, to ensure conformity with the program definition. Reports will be submitted to the CBS, with a copy to the IMF, no later than two months after each test date.

C. Primary Balance of the Consolidated Government (Cumulative Floor)

8. The consolidated government primary balance from above the line on a commitment basis is defined as total consolidated government and social security fund revenues (excluding privatization and long-term lease income receipts) less all noninterest (primary) expenditures of the government and social security fund.

D. Public External Debt (Ceiling)

9. The ceiling applies to the contracting or guaranteeing of new external liabilities by the public sector (including the central government, the CBS, and all public agencies and parastatals for operations that are not directly linked to commercial activities). The ceiling does not apply to the use of Fund resources, operations related to external debt restructuring; normal import related credits; purchases of treasury securities by nonresidents; or borrowing by parastatals in the conduct of normal commercial operations. The non-zero ceilings on the contracting or guaranteeing of external debt are to allow for normal public project finance and program support from multilateral institutions exclusively. Debt shall be valued in U.S. dollars at program exchange rates. A zero sub-ceiling on short-term external debt applies continuously to the contracting or guaranteeing of short-term external debt by the public sector, with an original maturity of up to and including one year.

10. For the purpose of this performance criterion, the term “debt” has the meaning set forth in point No. 9 of the Executive Board’s Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85)). Debt is understood to mean a current, non contingent liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future points in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. The ceiling on contracting official and officially guaranteed external debt includes all form of debt, including:

- a. loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);
- b. suppliers credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and,
- c. leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains title to the property. The debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.
- d. Arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt.

E. External Arrears of the Public Sector

11. The nonaccumulation of arrears to external creditors will be a continuous performance criterion under the program. External payments arrears for program monitoring purposes are defined as the amount of external debt service due and not paid within the contractually agreed period, including contractual and late interest. Arrears resulting from the nonpayment of debt service for which a clearance framework has been agreed or a rescheduling agreement is sought are excluded from this definition.

F. Budget Expenditure Arrears

12. The nonaccumulation of budget expenditure arrears will be a continuous performance criterion under the program. Budget expenditure arrears are defined as the sum of (1) any invoice that has been received by a spending agency from a supplier of goods, services, and

capital goods delivered and verified, and for which payment has not been made within the contractually agreed period, or in the absence of a grace period, within 30 days; (2) unpaid wages, pensions, or transfers, pending for longer than 30 days to domestic or foreign residents, irrespective of the currency denomination of the debt.

II. Data and Information

13. The Seychelles authorities (government and CBS) will provide Fund staff with the following data and information according to the schedule provided.

The CBS will report

Weekly (within one week from the end of the period)

- Reserve money.
- Foreign exchange reserves position.
- A summary table on the foreign exchange market transactions.
- The results of the liquidity deposit auctions, primary treasury bill auctions, and secondary auctions.

Monthly (within 4 weeks from the end of the month)

- The monetary survey in the standardized report form format.
- The foreign exchange cash flow, actual and updated.
- Financial soundness indicators.
- Stock of government securities in circulation by holder (banks and nonbanks) and by original maturity and the debt service profile report.

The Ministry of Finance will report

- **Monthly** (within 2 weeks from the end of the month):
 - Consolidated government operations on a commitment basis and cash basis in the IMF-supported program format.
 - The detailed revenues and expenditures of the central government and social security fund.
 - Monthly accounts of the public nonbank financial institutions.
 - Import and export data from the customs department.
 - Monthly public debt report.

14. The government and CBS will consult with Fund staff on all economic and financial measures that would have an impact on program implementation, and will provide any additional relevant information as requested by Fund staff.