International Monetary Fund

Republic of Seychelles and the IMF

Press Release:
IMF Executive Board Approves US$26 Million Stand-By Arrangement for Seychelles
November 14, 2008

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

October 31, 2008

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Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund

Dear Mr. Strauss-Kahn:

1. **The government of Seychelles is determined to decisively address Seychelles' balance of payments and external debt crisis.** Achievements in promoting high living standards and social development are in jeopardy. In 2006, the government initiated an economic reform program, but the global slowdown and sharp food and fuel price increases of 2007-08, have brought longstanding vulnerabilities to a head. In particular, pervasive foreign exchange restrictions and an overvalued pegged exchange rate are no longer tenable. These factors have led to acute foreign exchange shortages, an active parallel market, a sharp rise in inflation to over 30 percent, a depletion of our external reserves and external arrears accumulation. Following missed payments in July and October 2008 on our external commercial debt obligations Seychelles' external rating was downgraded to SD (selective default).

2. **We are seeking the support of the International Monetary Fund and the international community more broadly for a strong and comprehensive program aimed at restoring external and internal economic balances.** The program is described in the attached memorandum of economic and financial policies (MEFP) for 2008-09. This effort includes the removal of foreign exchange restrictions, a floating of the rupee, a significant fiscal and monetary tightening and the implementation of structural reforms to spur competitiveness and growth. At the same time, we have adopted a targeted social safety net that will help protect the most vulnerable segments of our population. We are preparing to initiate discussions with our external creditors with a view to reaching agreement on a restructuring of our external debt to close financing gaps and to restore public debt sustainability. In support of these important objectives, the Government of Seychelles hereby requests a two-year Stand-by arrangement in an amount of SDR 17.6 million (200 percent of quota).

3. **We believe that the economic imbalances and dislocation we are experiencing reflect the need for a broad-based reform of the public sector and economic policies, which will require several years to implement with the sustained support of our partners**. These reforms would entail, inter alia, a comprehensive review of the tax system and strengthening of tax administration, the downsizing of public sector employment, and reducing the role of the state in the economy, including further privatization of public enterprises. In this light, we will work with the IMF on developing a comprehensive

structural reform program that would be implemented over the medium term. Once this work is finalized, we intend to request a longer-term engagement with the Fund under the Extended Fund Facility.

4. **We believe that the economic and financial policies set forth in the MEFP are sufficient to ensure that the objectives of the 2008-09 program will be met.** If needed, we stand ready to take any further measures that may prove necessary to meet our objectives. We will consult with the Managing Director on the adoption of such measures in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. The Seychelles authorities will provide the Managing Director with all the information he may request in order to monitor program implementation and achieve program objectives on schedule.

5. **The quarterly quantitative performance criteria and indicative targets for end-2008 and 2009 are shown in Table 1**. The structural performance criterion and benchmarks are shown in Table 2. The completion of the first review under the program will be based, inter alia, on meeting the performance criteria and structural benchmarks at end-December 2008. The first review will focus on progress in: the reform of the exchange regime; the use of market-based monetary policy; normalizing relations with external creditors; strengthening tax administration and public expenditure management; the preparation of a fundamental review of tax policy; strengthening the CBS act and operations to address areas identified by the safeguards assessment; and a 2009 budget consistent with program objectives.

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

Sincerely yours,

/s/
James Alix Michel
President
Republic of Seychelles

Attachments:
Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Republic of Seychelles

Memorandum of Economic and Financial Policies For 2008-09

I. Introduction

1. **Over the past two decades Seychelles has successfully promoted high living standards and social development**. In Africa, Seychelles has the second highest GDP per capita, is one of six upper-middle-income countries, and leads in human development. It is ranked 50th on the 2007 United Nations Development Program Human Development Index, a level comparable to many OECD countries.

2. **Since the mid-1990s these achievements have been put increasingly at risk due to persistent macroeconomic imbalances, external shocks and long-standing structural problems.** Large fiscal and parastatal deficits have led to rising external and domestic debt and a widening current account deficit. The state's dominance in the economy has further restrained the development of the private sector.

3. **Recognizing these challenges, in 2003 we began a reform and modernization effort** (the Macro-Economic Reform Program─MERP), which entailed a large fiscal adjustment and tax reform, as well as a gradual liberalization of the economy. By early 2007, achievements included a sizable depreciation of the rupee, partial exchange regime liberalization and the replacement of collateralized debt with part of the proceeds of a Eurobond issue. In March 2007, we announced our "Seychelles Strategy 2017", a broad-based 10-year reform strategy which aims at a doubling of nominal per-capita income in ten years and a reduction of public debt from 145 percent of GDP to 60 percent.

4. **However, the pace of reform has been too gradual, piecemeal in nature, and insufficient to address the magnitude of the macroeconomic imbalances, so vulnerabilities remained high.** 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 we transformed a backlog of rupee deposits (totaling about 15 percent of 2007 GDP) awaiting conversion for transfer abroad into public external debt. 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. Standard and Poor's has downgraded Seychelles to SD (selective default).

5. **The current situation calls both for immediate measures to remove the distortions in the foreign exchange market and restore external and fiscal sustainability, as well as comprehensive structural reforms to sustain growth and competitiveness.** We have already taken measures in advance of commencing an IMF-supported program and have started laying the groundwork for future reforms. We will float the Seychelles rupee and have removed all exchange restrictions in order to restore confidence in our domestic currency. The change in exchange regime will be supported by a further significant tightening of fiscal and monetary policies, and we are putting in place a comprehensive debt restructuring strategy aimed at closing financing gaps and restoring debt sustainability. We are also preparing a comprehensive medium-term structural reform program that will remove existing distortions and obstacles to private sector development.

II. Recent Developments

6. **Growth in 2008 has slowed considerably, under the combined impact of the global slowdown, the oil and food price shocks, and foreign exchange shortages**. Real GDP growth is projected to be about 3.1 percent in 2008, down from 7.3 percent in 2007. While construction is still booming, manufacturing activities are sharply declining and growth in a key indicator of tourism activity (visitors nights) has fallen to about 4.5 percent since early 2008 (year to date), from 16.6 percent for the same period in 2007. Inflation has accelerated sharply since mid-2007, driven by a weaker rupee, price liberalization, and the surge in international oil and food prices.

7. **The 2008 budget has been implemented broadly as approved, delivering on the government's commitment to a significant tightening.** The primary surplus is projected at 5.6 percent of GDP in 2008 (excluding a 1.5 percent of GDP transfer of valuation gains from the Central Bank) compared to a 2.3 percent deficit in 2007). 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).

8. **The central bank (CBS) raised reserve requirements in response to rising inflation**. The reserve requirement on domestic currency deposits was increased from 5 to 13 percent as of June 1, 2008 and the same reserve requirement was introduced on foreign currency deposits in September. However, the local asset ratio (LAR—met only by holding domestic treasury obligations) was reduced from 65 to 50 percent, offsetting the increase in

reserve requirements. Following the decision to remove excess reserves as part of the LAR computation, the LAR was reduced from 50 to 45 percent on September 15, 2008.

9. **Based on mid-2008 data, commercial banks are adequately capitalized and have long net open positions in foreign exchange, but are vulnerable to interest rate and associated default risk.** As of June 30, banking industry assets totaled about SR 8.8 billion (113 percent of GDP). Domestic lending accounted for only about 25 percent of assets with most funds invested abroad (34 percent), and domestic government securities accounted for 24 percent. Bank regulatory capital, measured on the most stringent capitalization measure—net tangible capitalization (i.e., capital net of all provisions for loan loss and intangibles)—stood at 5.6 percent of net assets─40 basis points short of being considered well capitalized. However, banks' large position in treasury securities makes them vulnerable to declines in the values of those investments. Whereas industry capital as of June 30, 2008 covered about 22 percent of bank holdings of government securities, three banks had coverage of only 11-14 percent.

10. **The external current account deficit is projected to reach 29 percent of GDP in 2008**. The cost of transportation services imports is projected to increase by about 37 percent, while tourism earnings are being affected by the global slowdown, resulting in a significant deterioration of the services balance. The merchandise trade balance is, however, expected to improve somewhat, as the higher fuel and food import bill is largely offset by strong tuna exports and petroleum re-exports. As of end September official reserves had fallen to about US$15 million, and the balance of payments is increasingly financed by external arrears accumulation.

11. **At 151 percent of GDP (2008 figures), public debt is unsustainable.** External public debt represents about two-thirds of the total (97.8 percent of GDP), of which 81 percent of GDP is in arrears. We have a small amount of arrears (US$2.2 million at end-June 2008) to multilateral creditors. We have hired highly qualified financial and legal advisors to assist us in preparing a comprehensive debt strategy and engaging in good-faith discussions with our creditors.

III. ECONOMIC PROGRAM FOR 2008–09

12. The objectives of our reform program are to promote macroeconomic stability and sustainable growth by:

- Achieving full convertibility of the Seychelles rupee and introducing a market-determined exchange rate regime;
- Placing public debt on a sustainable path by implementing a comprehensive debt restructuring strategy, coupled with further tightening of fiscal and monetary policy, while preserving financial sector stability; and

- Reducing the role of the state in economic activity and enhancing the growth-generating capacity of the private sector by creating conditions conducive private investment.

13. The macroeconomic framework for the program period (2008-10) and the medium-term is:

Seychelles: Summary Table, 2006–2010

	2006 Act.	2007 Est.	2008 Proj.	2009 Proj.	2010 Proj.
	(Annual percentage change)				
Real GDP	8.3	7.3	3.1	-0.5	3.5
Consumer price index (average)	-1.4	5.7	32.2	33.8	12.6
	(Percent of GDP)				
Overall fiscal balance	-6.2	-9.8	-1.8	-6.1	-1.1
Primary balance	-0.6	-2.3	7.1	6.2	6.6
Total public debt	139.5	146.0	151.3	161.3	149.5
Domestic	85.8	74.1	53.5	41.5	34.3
External	53.7	71.9	97.8	119.8	115.2
Current account balance	-13.9	-23.4	-28.8	-20.9	-21.4

Sources: CBS; Ministry of Finance; and IMF staff estimates and projections.

- The program assumes a contraction in **GDP** in 2009 of about 0.5 percent, in part reflecting the recent deterioration of global economic conditions. A progressive recovery is projected in 2010 and beyond with average real GDP growth of about 5 percent, under the impulse of rising foreign investment in tourism following the lifting of exchange restrictions and other bottlenecks, which have hampered investment and growth.
- The **real effective exchange rate** is expected to depreciate sharply in late 2008, with small and gradual real appreciation thereafter.
- Reflecting pass-through of the anticipated exchange rate depreciation, **inflation** would peak in the second quarter of 2009 at about 41 percent and gradually decline to 22 percent at end-2009.
- **The current account balance is projected to improve significantly in 2009, to a deficit of about 21 percent of GDP, and to remain at about that level through the medium term**. Merchandise imports are expected to decline sharply (by about 10 percent in US dollar terms) in 2009 under the impact of the devaluation and a decline in FDI-related imports, before a gradual recovery broadly compatible with GDP growth in 2010 and beyond. The growth of goods exports is expected to be moderate at about 4 percent in 2009. Over the medium-term services exports, largely

tourism, are expected to grow more strongly under the impulse of rising direct foreign investment, improved competitiveness, and the elimination of exchange restrictions.

- **In the absence of external debt restructuring, public sector debt would increase to 169 percent of GDP in 2009, and remain at unsustainably high levels over the medium-term.** Domestic debt would decline through a combination of fiscal restraint and negative real interest rates, particularly on long-term bonds. Debt servicing capacity is extremely limited in 2009-11 and highly dependent on the availability of program lending from multilaterals.

A. Exchange Regime and Exchange Rate Policy

14. **We intend to reform fundamentally the exchange rate regime with a view to eliminate foreign exchange shortages, restore confidence in the Seychelles rupee as legal tender and enhance external competitiveness.** In particular we are committed to removing all exchange restrictions and allowing the exchange rate of the rupee to be market-determined.

15. **We believe that the current exchange rate peg is no longer viable, owing to the very low level of official foreign exchange reserves, limited external financing options, and large external debt obligations**. We have taken the necessary preparatory steps to ensure that the exit from the peg is as orderly as possible (below). The following preparations have been completed as of end-October 2008.

- Amend the Central Bank (CBS) Act to repeal CBS determination of the exchange rate.

- Repeal Foreign Earnings (Regulations) Act, under which the extensive exchange controls were imposed.

- Remove requirements to pay in foreign exchange.

- Revoke requirements under the Exchange Control Act that (i) persons who are not authorized dealers must conduct foreign currency transactions (i.e., buying, selling, lending, or borrowing gold and foreign currency) with authorized dealers; (ii) persons authorized to buy foreign currency in the course of their business must sell such foreign currency to financial institutions (i.e., banks and exchange bureaus).

- Amend the Financial Institutions Act to authorize a new class of foreign exchange bureaus that may operate in accounts in addition to notes, coins, and travelers' cheques.

In addition:

- We will prepare and submit to the National Assembly a modernized, simplified and transparent foreign exchange act by end-June 2009.

- With technical assistance from the IMF, we are establishing a platform at the Central Bank for interbank foreign exchange (FX) trading. While an augmented real-time gross settlement system should be introduced over the coming year, a manual book-entry system at the CBS will be used in the short term.
- We are reforming our monetary policy framework in order to conduct monetary policy based on reserve money targeting. Weekly auctions for 91-day treasury bills, and the establishment of a weekly auction for a central bank deposit facility (established in mid September) have already allowed for more efficient liquidity management and market-determined interest rates. The higher market-determined domestic interest rates observed in the run-up to the float will help contain possible exchange rate overshooting.
- We are working closely with commercial banks to ensure that they promptly establish internal rules for FX trading and risk management based on international best practices.

B. Debt Restructuring Strategy

16. **The success of our adjustment and reform program requires external financial support, including a restructuring of our external debt.** We are committed to sustaining a strong fiscal effort over the medium term. However, no plausible fiscal adjustment can deliver─on its own─funds sufficient to close our near term financing gaps and return our future debt service payments to sustainable levels. On September 30, 2008, we publicly announced that we would seek to restructure about US$800 million of external debt, and requested the support of our creditors. With the assistance of our legal and financial advisors, we are committed to developing a comprehensive debt restructuring strategy, consistent with the Fund's lending into arrears policy, with particular focus on information transparency, intercreditor equity, and dialogue with all creditor groups. We will seek a restructuring of our external liabilities aimed at restoring public debt sustainability, and consistent with our ability to pay. Immediate and sizable cash flow relief in the short- to medium-term, sustained reduction of our debt service burden, and significant balance of payments support from our international partners, will be necessary. With regard to domestic debt, we will need to assure the stability of our banking system which has a large portion of its assets in government debt. We have approached multilateral creditors with whom we have arrears seeking agreement on an arrears clearance strategy.

17. **Strengthening public debt management forms an integral part of our adjustment strategy.** We will submit to the National Assembly a Public Debt Law, defining a legal framework for public debt management, and specifying the roles and responsibilities of the bodies engaged in contracting and managing public debt by end-December 2008. As agreed with IMF staff, we will formulate a medium-term public debt strategy, aimed at achieving an optimal trade-off between cost and risk of public debt and consistent with long-run debt

sustainability. We will increase transparency of public debt management by publishing quarterly and annual reports on the implementation of the debt strategy. We also plan to strengthen the rules governing provision of government guarantees and start charging guarantee fees. We would welcome technical assistance in these areas from the IMF's Monetary and Capital Markets Department. As part of our strategy, we also commit to refrain from contracting or guaranteeing new loans outside of the limits set-out in the program, including project financing, and we will not accumulate new arrears to external or domestic creditors.

C. Fiscal Policy

18. **The further consolidation of public finances is central to the program.** 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. Primary surpluses of about 6.5 percent of GDP will be maintained in 2009-10, easing gradually over the medium term. These objectives will be achieved through a combination of expenditure restraint, including the elimination of subsidies and a reduction of the wage bill in real terms (from about 9.1 percent of GDP in 2008 to 6.4 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.

Fiscal measures

19. **We are committed to taking urgent measures to reinforce fiscal revenue**. We will apply the goods and services tax (GST) to all locally-manufactured and imported goods, except for 13 basic food items, and remove discretionary powers to grant exemptions. The following revenue measures will be introduced in the fourth quarter of 2008 according to the schedule below:

Action	Timing
Raise and harmonize taxes on locally-produced and imported cigarettes to SR500 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

and as part of the 2009 budget, we will introduce the following revenue measures:

Action	Timing
Raise environmental levy to SR25 from SR10 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

20. **We are committed to replacing costly and inefficient direct and indirect product subsidies with a well-targeted social safety net.** Over the past 20 years, the Seychelles' government has provided a generous and broad-based social safety net. Now, as the economy undergoes structural reforms to restore competitiveness, we are in the process of finalizing a review of the welfare system. The primary aim of this review is to adopt a multi-dimensional approach to the question of welfare support. This approach will aim at protecting the most vulnerable segments of our population that have been hard hit by the rise in inflation, particularly increased food prices. But the new safety net will go beyond monetary transfers, which in some instances can be a disincentive for people to seek employment: while providing assistance in a quick and effective way (applicants will receive a response within 3 days), it will also establish a means-testing system, and include an explicit exit strategy. The agency responsible for implementing the new welfare legislation will be operational by November 1, 2008, and will be funded out of the budget. The specific subsidies being eliminated include:

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 SR90 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 Coevity Prawns.	January 1, 2009
Eliminate LPG subsidy by the state oil company (SEPEC) (about SR3 per kg.).	January 1, 2009

21. **These changes are additional to the expenditure measures that have already been taken,** including the implementation in 2008 of a hiring freeze for the public sector; the establishment of a public enterprise monitoring unit in the Ministry of Finance to reinforce parastatal performance monitoring, reporting, better assess quasi-fiscal risks, and the enforcement of a full cost recovery policy in the provision of public utilities.

Fiscal structural reforms

22. **Strengthening the public financial management framework and the budgetary process should underpin and facilitate fiscal consolidation**. We will strengthen the budget formulation and execution process to ensure that resources can be allocated and used efficiently and that established spending limits are respected. In particular, an IMF mission recently conducted a public financial management review, and we commit ourselves to implementing its recommendations. In particular, we are reviewing options for expenditure rationalization as suggested in the report, including outsourcing non-core activities (see below), and plan to strengthen the budget preparation, implementation and monitoring processes, including through the preparation of a consistent medium-term macroeconomic framework.

23. **A high-level government task force, headed by the Minister of Finance, is laying the groundwork for major public service reform.** The task force is conducting a comprehensive review of the range of services provided by the government, with a view to eliminating duplication and to outsourcing services that can be provided more efficiently by the private sector. We believe public sector employment has become bloated and given continued strong demand for labor from the private sector, there is considerable scope for public sector employment rationalization. We intend to reduce the number of government employees by 12.5 percent in 2009 through a voluntary and involuntary departure scheme. A separation package is expected to provide sufficient time and means for former public employees to be retrained and employed in the private sector. A voluntary scheme will be conducted in October/November 2008, which would be followed by involuntary redundancies in the event that the voluntary scheme does not achieve the targeted employment reductions, with the departures scheduled to take place by January 1, 2009.

24. **We are convinced that a fundamental review of the tax system is urgently needed.** The current system has many differentiated rates of tax, high overall tax rates for businesses, and a significant number of exemptions, particularly for foreign investors. Our objective is to have a simple, fair, and equitable system, featuring low, harmonized rates and a broader tax base, which will reduce incentives for evasion. Such a fundamental review needs to be well prepared, and we have requested technical assistance from the IMF's fiscal affairs department.

25. Strengthened tax administration and improved governance are key in enhancing confidence that the tax system is fair and equitable. As an immediate step the Seychelles Revenue Commission has launched tax audits of the 20 largest enterprises (by turnover), in the tourism, banking, construction, and fishing sectors, to be completed by end-June 2009. We are also strengthening tax administration and reinforcing efforts to recover unpaid taxes. We have requested technical assistance on tax administration from the IMF's fiscal affairs department.

26. We are actively pursuing the further privatization of public enterprises, with a view to encouraging private sector activity. Parastatals are costly to the budget due to extensive direct and indirect subsidies, and some are involved in activities that can be more efficiently provided by the private sector. Our privatization program will continue over the next year with the divestiture of the Seychelles Savings Bank, the Agro Industries, the Animal Feed Factory and the Coetivy Prawn Farm. Going forward we intend to avoid retaining minority stakes in the firms we privatize. In March 2008 we created a government agency (Societé Seychelloise d'Investissement; SSI) to strengthen the monitoring of firms in which the government has a significant stake. In addition to the tax audits of the largest firms, the SSI will commission management audits of firms with large state holdings, including of the tuna cannery plant.

D. Monetary Policy

27. **Monetary policy will play an important role in seeking to establish price stability, with greater emphasis on liquidity management.** The CBS will rely more actively on market-based monetary policy instruments to achieve price stability following the shift to a flexible exchange rate. The exchange rate anchor will be replaced by a reserve money target, and indirect, market-based monetary policy instruments are being developed to allow the CBS to manage liquidity actively. As part of the new monetary policy, domestic interest rates have already increased and are likely to rise further, especially in the period around the floating of the rupee. The introduction of facilities for trading T-bills, foreign exchange and deposits at the central bank will promote more efficient liquidity management by commercial banks and support the development of an active inter-bank market. The new framework will create a healthier financial environment by improving efficiency and competition in the financial sector. The CBS and the government are committed to providing a regular and predictable supply of instruments over a range of maturities to facilitate market development and the establishment of a market-based yield curve.

28. **The CBS is committed to eliminating distortions in the financial market over the program period.** Burdensome financial regulations underpinning the current system of administrative monetary policy instruments will be streamlined and gradually phased out. In particular:

- The LAR will be phased out over the program period as conditions permit, in consultation with IMF staff, so as to promote lending to the private sector. It will be replaced by a supervisory liquidity requirement for prudential purposes, and financial supervision will be strengthened.
- Statutory commercial bank reserves will be remunerated at 0.25% per annum. However, excess reserves are no longer remunerated and no longer form part of the LAR.
- The CBS introduced weekly auctions for a liquidity deposit facility on September 22, 2008. Initially, deposits will be auctioned for 7, 14 and 28 days in amounts which will be determined by liquidity sterilization objectives.

- The CBS is also providing a facility for the trading of government securities at market rates of discount. Weekly auctions of 91-day T-bills started October 3, 2008.

29. **The CBS continues to need international support to build capacity for policy monitoring and implementation.** We have benefited from IMF technical assistance in central banking, foreign exchange markets and banking supervision. We welcome expert visits from the IMF's Monetary and Capital Market Department to continue to assist us in: establishing an interbank market in foreign exchange, government securities, and bank deposits with the CBS; initiating automation of this market; introducing a monetary framework based on reserve money targeting; and reinforcing banking supervision. Furthermore, we have requested a long-term monetary advisor to help us deal with the transition from a fixed to floating exchange rate regime.

30. **The CBS is committed to addressing areas identified by the IMF safeguards assessment mission of September 2008**. We have already invited international audit firms to tender for the external audit of the 2008 accounts. For the 2008 and future audits, we also commit to appointing only international audit firms with recognized experience in central bank audits. The 2008 audit requirements will be further formalized by developing a Supplementary Statement of Work, specifying, inter alia: (i) an audit partner with recognized experience in central bank audits, (ii) full compliance with International Standards on Auditing, and (iii) that quarterly audits of key monetary data, as specified in the TMU, will be conducted in addition to the financial statements audit. The data will be submitted to the IMF in conformity with the program quarterly quantitative performance criteria throughout the program period, beginning with December 2008 data. With IMF assistance, we also intend to strengthen the governance and transparency aspects of the CBS Act and CBS operations in 2008-2009, in line with the recommendations of the safeguards assessment and previous IMF recommendations in 2008-09. As a first step, we will address the current lack of formal procedures for CBS's transactions on behalf of government, in particular:

Action	**Timing**
Approve a memorandum of understanding, under Article 34 of the CBS act, formalizing the operational terms and conditions under which the CBS acts as agent for the government.	End-December 2008

E. Financial Sector Stability

31. **We are fully aware that the envisaged changes in the exchange rate regime and monetary policy framework will, against the background of global financial turbulence, pose challenges to the stability of the financial sector in the short run.** Based on tighter credit quality standards, and given that mid-2008 data showed strong net open positions in foreign currencies, a depreciation of the Seychelles rupee would improve the capital position of most banks. However, these foreign exchange positions can change quickly and we will closely monitor them. Another concern is the impact of higher interest rates on default rates

by borrowers. Government-owned financial institutions would also be affected both by exchange rate as well as interest rate risk.

32. **We are committed to carefully monitoring the impact of the exchange rate regime change on banks and non-banks' balance sheet, and to taking all measures necessary to maintain the stability and soundness of the financial system**. In this light, the government has provisioned a contingency in the 2009 budget to cover for potential losses and recapitalization needs of the state-owned financial institutions. A reassessment of the strategic role of public non-bank financial institutions will also be undertaken, and we are seeking technical assistance to create a specialized oversight function at the Ministry of Finance and advise on options available to the government.

F. Transparency and Good Governance

33. **Private investment is a key component of our country's sustained economic growth over the medium-term, and we shall take the necessary steps to ensure that all potential investors are treated with equity and with the highest level of transparency**. This will entail the revamping of the process by which new direct investment is attracted to remove discretionary incentives and ensure a level playing field. The authority for approving new projects will be centralized at the Ministry of Finance, with the final approval resting with the cabinet. We will ensure that the investment code is uniformly applied, and that all discretionary ministerial exemptions are removed.

34. **We are committed to enforce the highest standards of transparency and accountability in the public and private sectors.** In August 2008 we adopted 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, will be passed by 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.

G. Statistical Issues

35. **In spite of significant improvements, we recognize that there remain deficiencies in key macroeconomic data** – especially deflator estimates, and foreign trade statistics, which limit their usefulness for surveillance, economic analysis, and policy formulation. The government will further strive to improve the quality, periodicity, and timeliness of macroeconomic statistics. The government will request technical assistance in these areas

from the Statistics Department of the Fund. We will also strive to implement the GFS classification in order to present our fiscal accounts in the IMF format for easier budget monitoring and reporting.

H. Program financing

36. For 2008, the program is financed, after disbursement of US$1.6 million in financial assistance from the European Union and of the first tranche of the prospective SBA of 70 percent of quota (SDR 6.16 million) from the IMF. For 2009, the external nonproject financing requirement is expected to be covered by disbursements from the IMF under the prospective SBA (30 percent of quota; SDR 2.64 million; US$3.85 million), from multilateral creditors (US$15 million) and from external debt relief (US$85million).

IV. Program Monitoring

37. **The SBA will be monitored by quarterly program and financing assurances reviews.** The quarterly quantitative performance criteria and indicative targets for end-2008 and 2009 are shown in Table 1. The structural benchmarks and performance criterion for the first review are shown in Table 2. The non zero ceilings on the contracting or guaranteeing of external debt are to allow for nomal public project finance and program support from multilateral institutions exclusively.

38. **The completion of the first review under the program will be based on meeting the quantitative performance criteria at end-December 2008**. It will focus on progress in: the reform of the exchange regime; the use of market-based monetary policy, normalizing relations with external creditors; the preparation of a fundamental review of tax policy; the strengthening of tax administration and public expenditure management; strengthening the CBS act and operations to address areas identified by the safeguards assessment; and a 2009 budget consistent with program objectives. The first program and financing assurances review under the Stand-by arrangement is scheduled to be completed in early April 2009, and the second program and financing assurances review should be completed in early July 2009. 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. The authorities stand ready to adopt any additional measures, in consultation with Fund staff, which may become necessary to ensure program success.

Table 1. Seychelles: Quantitative Performance Criteria Under the Stand-By Arrangement, 2008-09
(Millions of Seychelles rupees; end-period data)

	2008			2009 [1]			
	June	Sept	Dec.	Mar.	Jun.	Sep.	Dec.
	Act	Est			Indicative		
Performance criteria [1]							
Net international reserves of the CBS, in millions of US dollars (floor) [2]	14	14	19	20	18	57	80
Reseve money (ceiling)	1282	1271	1151	1146	1261	1393	1386
Primary balance of the consolidated government (cumulative floor) [3, 4]	229	420	560	73	88	299	622
The contracting or guaranteeing of new external debt by the public sector (in millions of US dollars; cumulative ceiling) [3]			15	10	10	30	35
subceiling:							
The contracting or guaranteeing of new short-term external debt by the public sector (in millions of US dollars; cumulative ceiling) [3]			0	0	0	0	0
The accumulation of external payments arrears by the public sector (ceiling) [5]			0	0	0	0	0
The accumulation of domestic payment arrears by the public sector (ceiling)			0	0	0	0	0
Memorandum items							
External non project financing (in millions of US dollars; cumulative) [3]			0	-10	-23	-11	-19
Program financing support [3]			2	0	0	15	15
Cash payments on foreign debt service [3]			2	10	23	26	34
Program accounting exchange rates	8.00	8.00	14.00	14.00	14.00	14.00	14.00
SR/USD (end-of-quarter)	1.58	1.46					
USD/Euro (end of quarter)	1.99	1.84					
USD/UK pound (end of quarter)	1.63	1.56					
USD/SDR (end of quarter)							
Reserve requirement (percent of deposits)	13	13	13	13	13	13	13
Local asset ratio (percent of deposits)	50	45	45	45	45	45	45

Sources: Seychelles authorities and Fund staff estimates and projections.

[1] Targets for June, September and December 2009 are indicative.
[2] The floor will be adjusted downwards (upwards) for any shortfall (excess) in external non-project financial support from that assumed in the program.
[3] Cumulative flows from the beginning of the callendar year.
[4] The floor will be adjusted upwards for any unused amounts of the contingency in the budget for the recapitalization of the banking sector assumed in the program. Amounts of the contingency in excess of programmed amounts need to be funded within the program limits.
[5] The non-accumulation of new external payment arrears constitutes a continous performance criterion. Excludes arrears for which a rescheduling agreement is sought.

Table 2. Seychelles—Structural Benchmarks and Performance Criterion, 2008-June 2009

Measure	Target date	Status
Structural performance criterion		
• Complete tax audits by Seychelles Revenue Commission of the 20 largest companies (paragraph 25).	end-June 2009	
Structural benchmarks		
• Submit to parliament a Public Debt Law, defining a legal framework for public debt management, and specifying the roles and responsibilities of the bodies engaged in contracting and managing public debt (paragraph 17).	end-December 2008	
• Parliamentary approval of a Public Procurement Act (paragraph 34).	end-December 2008	
• Approve a memorandum of understanding, under Article 34 of the CBS act, formalizing the operational terms and conditions under which the CBS acts as agent for the government. (paragraph 30)	end-December 2008	

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 structural performance criterion and benchmarks for 2008-09 are listed in Tables 1 and 2 of the MEFP, respectively.

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 and free of any pledges or encumberments and excluding project balances held in CBS accounts), 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.

Net International Reserves of the CBS
(as of October 13, 2008)

	(in millions of U.S. dollars)
Net foreign assets of the CBS	92.7
Foreign assets	14.6
Official reserves (A)	14.6
Other claims	0
Foreign liabilities	0
Liabilities vis-à-vis correspondents (excluding IMF)	0
Liabilities to the IMF (B)	0
Other liabilities	0
Net International Reserves (A-B)	14.6

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.

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 should 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 new external balance of payments financing 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). Evaluation of performance of reserve money with respect to the program ceiling will take account of any changes in regulations affecting the level of banks' required reserves.

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 should be submitted to the CBS, with a copy to the IMF, no later than two months after each test date.

Adjusters

8. The reserve money target would be lowered (raised) for any reduction (increase) in the reserve requirements from those assumed in the program. A change in the reserve requirement coefficient will change the reserve money (RM) ceilings according to the following formula:

$$\Delta RM = \Delta r_D*DD_0 + \Delta r_F*DF_0,$$

where: DD_0 denotes the level of domestic currency deposits and DF_0 denotes the level of foreign currency deposits to which the reserve requirements for domestic currency and foreign currency deposits, respectively, apply during the period immediately preceding the date when the new reserve regulation becomes effective; Δr_D and Δr_F denote the change in the reserve requirement coefficient for domestic currency and foreign currency deposits, respectively.

C. Primary balance of the consolidated government (cumulative floor)

9. 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.

Adjusters

10. The floor on the primary surplus of the consolidated government will be adjusted upwards by the cumulative amount of the contingency for recapitalizing the state-controlled financial institutions which is not used for that purpose. Any amounts spent for the recapitalizing of the state-controlled financial institutions in excess of programmed contingency will need to be funded within the program limit on the primary balance.

D. Public External Debt (ceiling)

11. 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 non-residents; 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 nomal public project finance and program support from multilateral institutions exclusively. Debt shall be valued in U.S. dollars at program exchange rates.

- A zero subceiling 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. .

12. 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:

(i) 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);

(ii) 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,

(iii) 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 leasor 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.

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

13. The non-accumulation 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

14. The non-accumulation 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

15. 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):

- Net international reserves
- The CBS balance sheet.
- Contracts of any new external loan agreements entered into by the CBS.
- The daily average exchange rate of the Seychelles rupee for the previous five days (in Seychelles rupees per U.S. dollar) as posted by the CBS and a table on the number and size of daily transactions in the market.
- The foreign exchange cash flow.
- The results of the liquidity deposit auctions, primary treasury bill auctions, and secondary auctions.

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

- Monthly balance sheet of the CBS.
- The monetary survey.
- Financial soundness indicators.
- Structure of interest rates.
- Stock of government securities in circulation by holder (banks and nonbanks) and by original maturity.

The Ministry of Finance will report

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

- Notification of payments coming due on external debt, which were not made (increase in arrears).

Monthly (within 4 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 non-bank financial institutions.
- Monthly treasury report.
- Stock and flow of external debt by creditor.
- Statement on budget expenditure and external debt service arrears. Data on the clearance of arrears will distinguish between domestic and external obligations and between those referring to scheduled interest payments, scheduled principal repayments, and commercial and other current transactions.
- The contracts of any new external loan agreements entered into by the government and parastatals.

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.