International Monetary Fund

Seychelles and the IMF

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

Country's Policy Intentions Documents

June 1, 2010

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SEYCHELLES: LETTER OF INTENT

June 1, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington , D.C. 20431

Dear Mr. Strauss-Kahn:

1. The attached Supplementary Memorandum of Economic and Financial Policies for 2010–12 (MEFP) describes Seychelles' performance through end-April 2010 and updates macroeconomic and structural policies for the remainder of 2010, as well as our priorities through 2012. This MEFP complements and updates the MEFP of December 3, 2009 which set out the objectives of our three-year program supported by an arrangement under the Extended Fund Facility (EFF).

2. **We request completion of the first review under our EFF arrangement and the release of the third tranche of SDR 2.2 million (25 percent of quota) there under**. All the quantitative performance criteria (PCs) at end-March 2009 were met and the two structural benchmarks for end-March and end-April 2010 respectively were observed. We also request the modification of the quantitative performance criterion on the fiscal primary balance.

3. **We believe that the economic and financial policies set forth in the MEFP are sufficient to ensure that the objectives of the program will 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.

4. **The completion of the second review under the EFF will be based on meeting the quantitative PCs at end-September 2010 and is scheduled to be completed by end-December 2010**. Quarterly financing assurance reviews will continue as long as public debt arrears remain outstanding.

5. **In line with our commitment to transparency, we request that the IMF publish this letter, the MEFP, and the Technical Memorandum of Understanding.** We will simultaneously publish these documents in Seychelles.

Sincerely yours,

/s/

James Alix Michel
President
Republic of Seychelles

Attachments: SMEFP and TMU

Attachment I

Seychelles: Supplementary Memorandum of Economic, Financial and Structural Reform Policies for 2010–12

I. Introduction

This document:

- Reviews macroeconomic and financial performance under our Extended Fund Facility (EFF) arrangement through end-April 2010.

- Updates the MEFP of December 3, 2009, detailing our policy commitments through the remainder of 2010 to support completion of the second EFF review, as well as for the three year period 2010-2012 under the EFF arrangement.

II. Macroeconomic and financial Context

1. **Macroeconomic trends continue to evolve favorably, with recent developments generally exceeding expectations.** Economic activity was flat in 2009, rather than the anticipated contraction, consistent with early signs of recovery in the second half of the year. This positive momentum has continued into the first quarter of 2010, underpinned by an increase in tourist arrivals. Tourism activity has been maintained through deep discounting that has contributed to a significant decline in the terms of trade. Since December 2009 the nominal effective exchange rate has stabilized, with the rupee depreciating against the US dollar and appreciating against the Euro in similar proportions. Inflationary pressures remain well-contained, with the year-on-year inflation rate falling to -5.1 percent in April. T-Bill rates have declined to around 3 percent (91 day), consistent with tight fiscal policy and a measured easing in monetary conditions. However, credit growth has been slow to pick up despite adequate liquidity conditions, consistent with the slight recovery in domestic activity to date and with commercial lending rates adjusting only gradually to the financial sector's lower cost of borrowing. The reconstitution of gross international reserves has progressed strongly to $US190 million (2 months of imports) at end April 2010.

2. **Commercial banks remain well capitalized and there are no signs of deterioration in asset quality in the financial sector**. Based on first quarter 2010 data, the capitalization level of banks stood at 21.5 percent measured according to the Basel 1 capitalization standard and 10.4 percent on a net tangible capitalization basis. Total assets of the banking sector increased by 1 percent from December 2009 to March 2010. Relative to total assets, total credit remained at a low level, growing by a modest 3 percent. Notwithstanding the economic slowdown, nonperforming loans as a percentage of total loans have remained at 4 percent, indicating that credit remains of a high quality.

3. **There was no significant change in interest rates over the quarter**. The average weighted interest rate on savings deposits has remained stable at around 1.85 percent, which is a reflection of the high liquidity in the banking system. On the lending side, despite the reduction in prime lending rate by 1.9 percentage points to 10.9 percent in March, the average lending rate fell by only 43 basis points. The margin between the average lending and savings rates stood at 11.2 percent, highlighting the need for strengthened competition in our banking sector.

4. **The outlook is for economic recovery to gain traction from 2010 as activity responds to our first generation of reforms.** We are projecting that real GDP will grow by 4 percent in 2010, building on the momentum in the second half of 2009, and driven by a projected 8 percent rise in tourism arrivals. Deflationary pressures are expected to wane as economic activity picks up and the pass through of the rupee appreciation experienced in 2009 abates. Risks to the improved economic outlook include the potential impact on tourism and related investment of economic developments in Europe and any further disruption to air services arising from volcanic activity in Iceland. Piracy in the Indian Ocean has had a negative impact on both our fishing and tourism sectors, with any further escalation presenting both economic and fiscal risks.

III. Program Implementation and 2010 Program Update

5. **The major objectives of our EFF-supported program are to:**

a. consolidate macroeconomic stability;

b. complete debt restructuring and achieve external sustainability; and

c. improve economic efficiency and durably raise growth through the implementation of a second generation of structural reforms.

6. **Our ambitious structural reform agenda aims to transform the economy by institutionalizing higher governance standards, rationalizing the public sector and improving the business environment**. As detailed below, we are making good progress against the three structural reform pillars established under our EFF arrangement - public enterprise restructuring, tax reform, and strengthened public financial management. Our EFF arrangement also provides the macroeconomic framework for working with other development partners (such as the World Bank, African Development Bank and European Union) on enhancing the role of the private sector in the economy.

7. **The government has continued to exceed its fiscal targets and is determined to maintain its strong track record in this regard.** The primary fiscal surplus in 2009 was 14.9 percent of GDP, representing a fiscal contraction of some 11 percentage points of GDP compared to 2008. The primary surplus for the first quarter was 2.7 percent of GDP, exceeding the target established at the commencement of our EFF arrangement by

0.3 percentage points. This result was driven by both lower expenditures and higher revenue collection, in part due to stronger than anticipated economic activity in 2009 and the recent depreciation of the rupee (boosting GST on imports).

8. **Price stability remains the primary objective of monetary policy**. Our success in containing inflation over the past year, and the significant appreciation of the rupee, allowed for a loosening of monetary policy from the third quarter of 2009, which has arrested the decline in prices in April 2010.While a buildup of liquidity - due in part to faster-than-expected repayment of domestic debt by the government - has made monetary policy more challenging, we have succeeded in meeting both our reserve money and net international reserves targets with margins. We remain committed to the float of the rupee and to completing the move to indirect monetary instruments as conditions allow. The CBS continues to closely monitor credit and price developments and stands ready to tighten monetary policy should inflationary pressures emerge.

9. **We have made significant progress in normalizing relations with external creditors.** Reflecting this, the external debt stock declined from 92 percent of GDP in 2009 to 54 percent of GDP in March 2010. Fitch Ratings assigned a single-B rating with a positive outlook to external debt, and declared that it considered the Seychelles default to be cured.

10. **All quantitative PCs at end-March were met with margins (Table 1) and we have implemented all structural benchmarks scheduled for completion prior to the first EFF review (Table 2).** Table 4 provides an update of our broader economic reform program, both adding to and updating the timing of measures detailed in our previous MEFP.

Fiscal Policy

11. **The overarching goal of fiscal policy remains to put public finances on a sustainable path, while creating the fiscal space to raise public investment and support our targeted social safety net.** At the onset of the program, primary fiscal surpluses were targeted at 13.4 of GDP in 2009, 7 percent of GDP in 2010, declining to about 4½ percent by 2012. We have exceeded the 2009 target and plan to also exceed the program target for 2010, which will accelerate progress toward fiscal sustainability, assuming full external debt restructuring, and allow us to further reduce domestic public debt, releasing resources to support private sector development.

2010 Budget

12. **Based on the outcome of the first four months, we now project higher government revenue by the equivalent of 1 percent of GDP, half of which will be saved.** Higher projected revenue comes from a combination of higher dividends from several public enterprises and revenue over performance in the first four months of 2010. Additional

current spending includes the cost of termination benefits associated with extending our program of outsourcing noncore functions beyond ministries and departments to all budget-dependent agencies, the higher-than-budgeted cost of the new wage grid and scheme of service for teachers and health professionals (with a view to arresting the ongoing exodus to the private sector), as well as urgent but unforeseen spending on goods and services. The fiscal margin freed by the accelerated repayment to the government of loans to public entities and the partial release of the capital expenditure contingency agreed at the commencement of our EFF arrangement will fund additional infrastructure as well as the increased cost of some investment projects. Looking ahead, SR 35 million will be released from the contingency provided the primary balance through June 2010 remains on track; and the remaining 25 million will be released provided the primary balance through end-September 2010 remains on track.

Tax Reform

13. **We launched a comprehensive reform of the tax system with the 2010 budget.** Our objective is to have a simple, fair and equitable system, which will promote growth, improve self compliance, and level the playing field for investors. Our tax reform comprises three pillars:

a. The first stage was the introduction of **a revised Business Tax Act** from January 1, 2010. The business tax reform broadened the tax base and provided for a step-wise reduction in rates to promote competitiveness and achieve harmonization across sectors. As a first step, the maximum rate has been revised downward by 7 percentage points, to 33 percent. The tax-free threshold was abolished for companies and reduced for sole traders and partnerships.

b. The second stage will be the **introduction of a withholding-based personal income tax** (PIT) from 1 July, 2010 on wages to replace social security contributions, expanding the labor income tax base to resident expatriates and eliminating existing sectoral concessions. Government policy is to broaden the application of the PIT to other sources of domestic-sourced income (e.g., dividends and interest on savings) once the PIT becomes established and the new system has been assessed. PIT rates will be harmonized at 15 percent, for all categories of workers, effective January 1, 2011. The PIT legislation has been approved by Cabinet and will be introduced in the National Assembly in June 2010.

c. The third pillar of the Government's tax reform strategy is the **introduction of a Value Added Tax** (VAT) from January 1, 2012. The VAT will replace the current multiple rate GST, broadening the indirect tax base and improving both the efficiency of the indirect tax system and external competitiveness. Important steps in this direction were taken in the 2010 Budget, including expanding the GST base to a broader range of services and the reduction of cascading effects through the option of levying GST either on imports or sales. The concessional 10 percent GST rate that currently applies in the tourism sector will be raised to 12 percent in November 2010, prior to alignment with the general GST rate of 15 percent by November 2011 in preparation for the introduction of the VAT. The design of and preparation for the VAT will be supported by technical assistance financed by the EU (€1 million has been set aside for this purpose in 2010).

14. **The reforms are expected to be broadly revenue neutral over the medium-term and will be accompanied by efforts to modernize and reinforce revenue administration.** With a view to establishing a level playing field for all businesses by the time of the VAT introduction, we have also maintained our policy of not providing new tax incentives and exemptions and made progress on our goal to phase out existing ones.

15. **Several steps have been taken to improve SRC governance, including Cabinet approval of a new organizational structure in December 2009 and the passing of the Revenue Administration Act and the Business Number Act.** We plan now to accelerate the restructuring of SRC operations through the setting up of an audit group focused on large taxpayers. The new structure is expected to be fully operational by July 2010. On customs, we are starting to implement the customs reform strategy and implementation plan that the Cabinet approved in March. We also plan to submit to National Assembly a new Customs Management Act by end- September 2010.

Public Financial Management and Expenditure Reform

16. **We are making considerable progress towards strengthening public financial management, in line with recommendations from the IMF's Fiscal Affairs Department.** The introduction of a Treasury Single Account (TSA) in late 2009 represented a major step forward in our capacity to both monitor and control public expenditure and manage the government's cash balances. We will also introduce a new chart of accounts in the 2011 Budget with the Fund's technical assistance. We have set up a monitoring committee to follow up on the recommendations arising from audits conducted by the Auditor General (statutory) and internal auditors (ad hoc) in each government department on internal controls and procedures.

17. **Our fiscal policy objectives will be supported by strengthened budget processes**. Starting with the 2011 Budget, we will move to a medium-term budgeting framework, presenting the government's fiscal and economic projections over a three-year horizon. The 2011 budget process will commence in June 2010 with Cabinet's discussion of a budget strategy document, setting the fiscal context and establishing the government's priorities. Ministries and other budget dependent entities will then submit their recurrent and capital expenditure proposals to the Ministry of Finance using a standard template that will detail the costing. The Ministry of Finance's capacity to scrutinize these expenditure proposals will also be enhanced through increased resources, the introduction of formal expenditure

review procedures and detailed reconciliation of budget estimates with quarterly and year-end outcomes. 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.

18. **We are also working towards a more complete presentation of the budget.** The 2010 Budget document presented to National Assembly was more detailed than in previous years, including for the first time a full presentation of revenues, expenditure and financing, an annual borrowing plan and a medium-term debt strategy. The 2011 Budget will build on these achievements by presenting a more comprehensive analysis of the fiscal position and macroeconomic context and incorporating the Pension Fund into the general government accounts. A related work stream is the review of the operations of all public sector agencies, based on a classification by type of economic activity. Based on this classification, we have started to compile and publish consolidated general government accounts, consistent with international standards. It is also anticipated that this analysis will lead to the commercialization of some existing public sector agencies, in line with our broader strategy of reducing the role of the state in the economy.

19. **We are committed to improving public infrastructure, including addressing urgent needs in the utilities sector.** We will develop a memorandum of understanding between the government and Public Utilities Company (PUC) to promote strengthened collaboration on investment plans and tariff schedules in the utilities sector and will enhance financial oversight of PUC through the Public Enterprise Monitoring Division (PEMD) in the Ministry of Finance. While further work is required to identify priority investments in the utilities sector (e.g., electricity, water and sewage), following several years of under-investment, the government's preliminary estimate is an investment need of over SR 2 billion over the next three years. The Public Utilities Company (PUC) has limited capacity to finance this investment internally, with the existing tariff structure – specifically, a substantial subsidy for household electricity consumption – insufficient to meet the costs of supply. The government's objective is to improve the quality of service provision in the utilities sector, which over the medium-term will require PUC to implement a tariff policy that is consistent with full cost recovery and meeting future investment needs. To this effect, we will commission a comprehensive study of the tariff structure, production costs and the quality of service provision in the utilities sector that will make recommendations to government on the optimal tariff policy in July 2011. The study will also include a social impact statement to inform the government's response. Meanwhile, most of the capital expenditure contingency is being directed to urgent utilities investment in 2010.

20. **Our social safety net is successfully delivering targeted income support without undermining incentives to work.** The number of income support recipients has decreased over the last year, in line with strengthened compliance and is expected to decline further as the economy recovers and job prospects improve. We have expanded training programs for the unemployed and those exiting the public service through the voluntary departure scheme

to ensure that any period of unemployment is transitory. We are also working with the World Bank to fine-tune the targeting of our social safety net, including establishing a relationship to the minimum wage that preserves work incentives over time.

21. **We will strengthen the Ministry of Finance's budgetary oversight of the Social Security Fund (SSF), improve the management of its assets , and initiate work on a medium-term strategy that will put our social security institutions (including the Pension Fund) on an actuarially sound basis**. Today, the SSF has substantial financial assets, including sizeable cash balances with commercial banks. The financial operations of the SSF will change when the current social security contribution is replaced with the personal income tax. The Ministry of Finance will conduct a financial audit of the SSF, strengthen budgetary oversight of the SSF's financial operations and will help the SSF to rationalize its cash management. Concurrently, the World Bank is providing technical assistance on the institutional arrangements for merging the Social Security Fund and the Social Welfare Agency, reviewing the functions of the SSF and advising on the transfer of its assets and liabilities. Furthermore, as part of our medium-term reform program, we will also initiate an actuarial audit of the SSF as well as work on a comprehensive asset management strategy for the general government sector that aligns with the government's debt management strategy and takes into account accruing liabilities.

22. **Efforts to improve transparency and strengthen institutional capacity in the area of fishing licenses remain a work in progress.** There has been a marked decline in the number of licensed fishing vessels operating in our waters since 2008, when piracy in the Indian Ocean became more prevalent. Work is continuing on the disclosure of fishing license agreements and the construction of an economic and financial model to support more informed fishing licensing and natural resource management policies (see ¶27 of previous MEFP).

A. Monetary and Exchange Rate Policies

23. **Monetary policy will continue to be based on reserve money targeting through the use of indirect instruments**. We will continue to use repos to guide short-term interest rates. Furthermore, we will be lengthening the maturity structure of the Deposit Auction Arrangement (DAA), which will provide for more flexibility in open market operations.

24. **We are continuing to enhance coordination between monetary and fiscal policy to promote sound liquidity management and financial sector deepening.** To this end, we will continue to make extensive use of the liquidity forecasting and reserve money programming framework. The CBS and the Ministry of Finance 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 yield curve. We will also communicate the calendar of T-bill issuance weekly for the following four week period and inform the market of the quantity of paper to be issued three days ahead of the auction to improve predictability and

assist banks in better managing their liquidity. The CBS will also formalize the arrangements for its use of government securities as a monetary policy instrument through a memorandum of understanding with the Ministry of Finance by end-June 2010.

25. **We remain committed to a floating exchange rate regime, which has served Seychelles well during the initial phases of our 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, to improve the efficiency of the inter-bank foreign exchange market. Within 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.

B. CBS Governance and Capitalization

26. **The implementation of an integrated (core) banking system is on course for completion by the fourth quarter of 2010.** This project will assist the CBS to (i) significantly improve the efficiency of its operations; (ii) modernize banking services; and (iii) significantly minimize IT risks. The implementation and license agreements have been signed by CBS and the selected vendor and a detailed project plan has been agreed to by the two parties. Work has already started and a complete gap analysis is being conducted by the selected vendor with the assistance of the external auditors.

27. **The CBS is undercapitalized, which if left unaddressed, could constrain its ability to implement prudent monetary policies.** Significant valuation losses in 2009, due to the appreciation of the rupee, have affected CBS's distributable profits (R40.0 million). With the 2009 results, 50 percent of the distributable profit equivalent to R20.0 million was retained to build up CBS capital which currently stands at 2.68 percent of monetary liabilities. As per the CBS Act, the government will implement a one-time recapitalization in 2010, boosting CBS capitalization to 10 percent of monetary liabilities by the end of the year. This will strengthen the balance sheet of the CBS and enhance its portfolio of tradable securities to be used in open market operations.

28. **As external reserves continue to accumulate, the CBS will need to continue to strengthen its reserve management activities.** Given its internal capacity constraints, we consider it premature at this stage to use commercial asset managers to manage a portion of our reserves, and instead will use the services of the World Bank's Reserve Advisory and Management Program (RAMP) and the Asset Management services of the Bank for International Settlement (BIS). The World Bank and the BIS have been approached to conduct a peer review of the CBS' reserve management activities (investment guidelines, investment committee etc). These institutions are expected to provide technical assistance in the area of capacity building, training of CBS internal managers in order to adequately manage the Bank's reserves, as well as investing a portion of CBS' external reserves.

29. **A reputable international audit firm is conducting a thorough risk assessment of the central bank to improve its internal controls**. As part of the assessment the team will also provide training to CBS officers in the way forward to address these risks. CBS management is committed to monitor risks on a permanent basis and to ensure that high risk areas are properly mitigated, and that the internal audit functions of the Bank are strengthened.

30. **CBS plans to complete the introduction of a business continuity plan (BCP) by end-2010.** A contract will be tendered by mid-June to a consulting firm to assist it in this exercise. The first BCP will cover the priority services offered by the CBS and this will later be expanded to incorporate all other services.

C. Financial Sector Reforms

31. **We will continue our efforts towards implementing a risk-based approach to supervision, in line with the Fund technical assistance recommendations**. This is expected to be fully operational by mid 2011. Frequent onsite examinations are being conducted as per the manuals developed with the IMF's technical assistance. Minimum capital for banks has been doubled, with a three year transition period granted to existing banks.

32. **We remain committed to adopt the best supervisory practices in the region. CBS will implement the Banking Supervision Application software**[1] to strengthen its supervisory process, especially offsite supervision. This is expected to be fully operational beginning 2011.

33. **The CBS continues to be proactive in its effort to safeguard the financial sector stability.** At the request of CBS, the Toronto Centre[2] has agreed to provide training on crisis preparedness, tentatively in August when the main sections of the crisis preparedness plan will be drafted. This will document the process to manage financial crises and promote coordination between authorities.

34. **Seychelles will continue its efforts to promote transparency in the offshore financial sector** through strengthened supervision by the central bank in coordination with the Seychelles International Business Authority, and the Financial Intelligence Unit. To that effect a two phase review is being conducted by the Global Forum on Transparency and Exchange of Information for Tax Purposes which is expected to be completed by September 2010.

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[1] Developed initially by ESAF/SADC, which is continuously being upgraded.

[2] This is an institution that provides technical assistance in the area of financial supervision. Both the IMF and the World Bank are represented at the Board of the Toronto Centre.

35. **We are committed to encouraging a sound and efficient insurance sector that promotes policyholder confidence.** The CBS has submitted to First Initiative a project proposal for technical assistance to strengthen the supervisory process of insurance supervision. This will include review of the regulatory framework and preparation of manuals for conducting examination of insurance and insurance-related companies.

36. **We will continue to modernize the national payment system.** Several important steps were taken in 2009 and in the first quarter of 2010, including the establishment of a complete requirements and standards document for electronic funds transfers that replaced the manual settlement system. The adoption of the new cheque standard documents in July 2009; the new clearing house rules in April 2010; and the introduction of the National Clearing and Settlement system bill in June 2010 will facilitate the introduction of the Electronic clearing house system. 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.

D. External Sector Policies

External Debt Restructuring

37. **We are making considerable progress in normalizing relations with external creditors.** To date, restructuring agreements covering approximately US$575 million, or around 85% 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. Remaining balances have by and large been rescheduled over periods exceeding 17 years at low rates of interest.

38. **In February 2010, the country's commercial debt exchange offer closed successfully with a 50% debt cancellation.** The transaction, which was launched in December 2009 following a period of discussions with key affected creditors, sought to restructure the bulk of Seychelles's external commercial debt. Claims with a face value of US$320 million were eligible to participate in the exchange offer, including the US$230 million Eurobond, the €55 million Amortizing Notes and two commercial bank loans held by three banks. The debt exchange was supported by a guarantee from the African Development Bank. Upon the expiry of the exchange offer period, 84% of the face value of the Eurobond had been tendered, along with 100% of the Amortizing Notes and the two bank loans. After the triggering of the collective action clause in the Eurobond by bondholders, Seychelles achieved 100% participation for the exchange. This transaction alone cancelled approximately US$225 million in principal, accrued interest, and other charges.

39. **Seychelles 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 claims.** Since the approval of the Extended Fund

Facility, bilateral restructuring agreements have been reached with four commercial banks covering eight facilities. The three smallest loans in this category were bought back by Seychelles at steep discounts to face value, with the remainder being rescheduled at par over the long term at low interest rates. The vast majority of these claims were converted into new rupee-denominated loans or bonds. The Government has reached comprehensive restructuring agreements with Libya and Malaysia, and is close to reaching agreements with two other non-Paris Club official bilateral creditors. The Government expects to sign its remaining Paris Club bilateral agreements ahead of the second tranche of Paris Club debt cancellation on 1 July 2010.

Trade Policies

40. **We remain committed to further liberalize our foreign trade policies**. We remain on track for the implementation of the COMESA common external tariff by 2013. As a preliminary step, we have introduced in the 2010 budget a common excise tax on petroleum, motor vehicles, alcohol and cigarettes that applies equally to imports and locally-produced items. A roadmap has been established and a chief negotiator has been appointed to prepare for the negotiations to accede to the World Trade Organization.

E. Public Enterprise Reforms

41. **The government is pursuing a public enterprise reform strategy aimed at achieving greater efficiency, transparency and accountability.** The Cabinet has approved a detailed work plan for the Public Enterprise Monitoring Division (PEMD) directed at reinforcing the monitoring and control of public enterprises, strengthening governance, reducing dependence on public funding and minimizing financial risks to the state. The legal basis for this work was established with the approval of the Public Enterprise Monitoring and Control Act (the Act) by the National Assembly in late 2009, mandating strengthened oversight and reporting arrangements for public enterprises and setting uniform governance rules. Financial audits will continue to be regularly examined by the Public Accounts Committee of the National Assembly, in line with the Act. The Public Enterprise Monitoring Division has finalized strategic assessments for the largest public entities—drawing on recently concluded external financial audits and management audits. All these public entities have submitted statements of intent and action plans. They have taken the necessary steps to establish the following committees: procurement and investment, audit and finance, and remuneration, in line with audit recommendations. We have also commissioned an international aviation consultant to conduct a strategic assessment of the future of Air Seychelles and its ancillary services. The consultant is scheduled to report findings to the government in August 2010.

42. **The government, together with the CBS, is strengthening the management and oversight of public financial institutions and assessing the case for continued state ownership**. It is government's policy to privatize Nouvobanq in the context of our medium-

term strategy. Regulatory oversight of the Development Bank of Seychelles (DBS) and the Housing Finance Company (HFC) has shifted from the Ministry of Finance to the CBS, leveraging off the CBS' financial sector expertise. The First Initiative is scheduled to assess the government's strategic options with regard to both DBS and HFC in the second half of 2010. We recognize that, in the longer term, privatization of the two publically-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. An IFC mission is scheduled for August to explore the government's options with regard to Nouvobanq and add more definition to the time of its future sale.

F. National Statistics

43. **We remain strongly committed to improving the quality, periodicity, and timeliness of macroeconomic and financial statistics.** A new National Statistics Act (NSA) which will be presented to the Cabinet in June 2010, reinforcing the National Statistics Bureau's (NSB) independence and strengthening its mandate to collect data. 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-January 2011.
We will bring Seychelles in line with international best practice, by aiming to implement the IMF's Special Data Dissemination Standard (SDDS) and the Balance of Payments and International Investment Position Manual 6 by 2011. The Ministry of Employment will reinforce its efforts to produce high-frequency labor market data. We have requested technical assistance from the IMF Statistics Department (on fiscal and national accounts) and the World Bank (to strengthen the management and operations of the NSB).

G. Program Monitoring

44. **The EFF-supported program will be monitored by semi-annual program reviews, with quarterly quantitative performance criteria and disbursements**. The quarterly quantitative performance criteria (QPCs) for 2010 are shown in Table 1. The structural benchmarks for 2010 are shown in Table 2. The nonzero ceilings on the contracting or guaranteeing of external debt are to allow for budgeted public project finance and program support from multilateral institutions exclusively.

45. **The completion of the second review under the EFF will be based on meeting the QPCs at end-September 2010**. The second program review will be based on meeting the end-September 2010 QPCs and is scheduled to be completed by end-December 2010. It will focus on the 2011 Budget, progress in implementing the tax reform, and in strengthening

public financial management. Quarterly financing assurance reviews will continue as long as public debt arrears remain outstanding.

46. **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. Seychelles: Quantitative Performance Criteria Under the EFF, December 2009–December 2010
(Millions of Seychelles rupees; end-of-period)

	2009			2010								
	December			March			June		September		December	
	Program	Adjusted	Actual	Program	Adjusted	Prel.	Program	Rev.prog.	Program	Rev.prog.	Program	Rev.prog.
Performance criteria												
Net international reserves of the CBS, millions of U.S. dollars (floor) [1]	130	138	153	133	137	192	128	128	142	142	168	168
Reserve money (ceiling)	1,480	…	1,296	1,537	…	1,424	1,592	1,592	1,676	1,676	1,753	1,753
Primary balance of the consolidated government (cumulative floor) [2, 3]	1,375	…	1,586	261	…	298	437	455	659	668	761	823
The contracting or guaranteeing of new external debt by the public sector (Millions of U.S. dollars; cumulative ceiling) [2]	39	…	30	2	…	0	3	3	13	13	37	37
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	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	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	0.0	0.0	0.0	0.0	0.0
Memorandum items:												
External non project financing (millions of U.S. dollars; cumulative) [2]	-17.2	…	-9.3	1.7	…	5.6	1.8	1.8	9.0	9.0	31.8	31.8
Program financing support	19.6	…	11.2	0.0	…	8.7	0.0	0.0	0.0	0.0	19.6	19.6
Cash payments on foreign debt service	48.1	…	32.0	1.8	…	3.9	5.8	5.8	6.9	6.9	9.2	9.2
External budget grants	11.3	…	11.5	3.5	…	0.8	7.6	7.6	15.9	15.9	21.4	21.4
Program accounting exchange rates												
SR/US$ (end-of-quarter)	11.00	…	11.25	11.00	…	11.00	11.00	11.75	11.00	11.75	11.00	11.75
US$/Euro (end-of-quarter)	1.48	…	1.43	1.48	…	1.48	1.48	1.27	1.48	1.27	1.48	1.27
US$/UK pound (end-of-quarter)	1.65	…	1.62	1.65	…	1.65	1.65	1.48	1.65	1.48	1.65	1.48
US$/SDR (end-of-quarter)	1.59	…	1.57	1.59	…	1.59	1.59	1.49	1.59	1.49	1.59	1.49

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.

Table 2. Seychelles: Structural Benchmarks, 2009–10

Measure	Target date	Macroeconomic rationale	Status
Introduce a treasury single account.	End-September 2009	To strengthen public finances, key to sustainability efforts.	Met. The TSA is leveraging progress on PFM.
Adopt foreign reserves management investment guidelines.	End-September 2009	To ensure management of foreign reserves in line with best international practice.	Met. The CBS Board adopted guidelines on September 25, 2009.
Adopt Public Enterprise Monitoring and Control act.	End-September 2009	To improve oversight over public enterprises and reduce quasi-fiscal risks.	Met. Parliamentary approval secured on September 28, 2009.
Complete CBS procedures manual (MEFP, ¶46).	End-December 2009	To support improved efficiency and transparency in monetary policy.	Met. The manual was approved on December 29, 2009.
CBS to publish commercial bank supervision report (MEFP, ¶46).	End-December 2009	To promote competition and transparency in the banking system.	Met. Published on the CBS website on December 29, 2009
Amend the Business Tax Act in line with the tax reform strategy (MEFP, ¶22).	End-December 2009	To broaden the tax base, modernize tax policy, and remove distortions.	Met.
Cabinet approval of customs reform strategy and implementation plan (MEFP, ¶23).	End-March 2010	To transform customs into a modern and efficient entity.	Met. The approval was secured on March 17, 2010.
Publish general government fiscal statistics (MEFP, ¶29).	End-April 2010	To enhance transparency and coverage of public finance.	Met. Fiscal statistics were published on April 23, 2010
Submit to National Assembly a new customs management act (MEFP, ¶23).	End-June 2010	To institutionalize best international practice and a better business climate.	Moved to end-September 2010, to address regional harmonization issues.
Introduce Personal Income Tax (MEFP, ¶22).	July 1, 2010	To broader the tax base and provide for more equitable taxation.	
Introduce budget submissions protocols and procedures (MEFP, ¶28).	End-July 2010	To strengthen budget preparation.	
Adopt a new chart of account for the 2011 budget (MEFP, ¶29).	End-November 2010	To ensure proper classification and increase efficiency of the budget as a policy tool.	
Submit to National Assembly a bill creating a national clearing house and settlement system (MEFP, ¶44).	End-December 2010	To introduce necessary financial infrastructure for improved efficiency and reduced risks.	

Table 3. Seychelles: Principal Structural Reform Measures Implemented in November 2009–April 2010

Action	Timing
Fiscal Policy	
Increase in GST on tourism to 10 per cent	November 2009
Extend budget coverage for 2010 to include: full presentation of revenues, expenditure, and financing; discussion of macroeconomic assumptions and objectives; fiscal targets and objectives; and an annual borrowing plan.	December 2009
Publish a medium term debt strategy with the 2010 Budget	December 2009
Introduction of Revenue Administration Act and Business Number Act.	December 2009
Introduction of a revised Business Tax Act	December 2009
Reduction in cascading through levying GST on either imports or sales	December 2009
Partial conversion of Trade Taxes to Excise Duties (petroleum, cigarettes and alcohol)	January2010
Extend partial excise on petroleum to PUC	January2010
Introduction of a new public sector wage grid	January2010
Introduction of a new Budget calendar	March 2010
Publication of monthly fiscal report on the Ministry of Finance website	March 2010
Cabinet approval of the Customs Reform Strategy and implementation plan	March 2010
Public Enterprise Reform	
Secure services of aviation consultant for strategic assessment of Air Seychelles	November 2009
Cabinet approval of a public enterprise reform strategy and work plan for PEMD	December 2009
Commence establishment of performance benchmarks for public enterprises	December 2009
CBS Governance and Capitalization	
Completion of the CBS Procedures Manual	December 2009
Publication of the Commercial Bank Supervision Report	December 2009
Introduction of new methodology for calculating application and annual license fees for domestic and offshore banks	March 2010
Adopt IFRS for 2009 CBS Accounts	March 2010
National Statistics	
Publication of the General Government Fiscal Statistics	April 2010

Table 4. Seychelles: Principal Structural Reform Measures in Progress at May 2010

Action	Timing
Fiscal Policy	
Cabinet approval of 2011 Budget Strategy	June 2010
Introduction of a new Auditor General's Act	June 2010
Establish guidelines for government guarantees	June 2010
Introduce standardized tender bidding document for all public procurement	June 2010
Half-yearly budget review of expenditure by all government departments	July 2010
Establish a comprehensive Government Assets Register	August 2010
Adopt a new chart of accounts for the 2011 Budget	November 2010
Determine budget treatment of all budget dependent agencies	December 2010
Budget management training for departmental budget officers	Jan – Dec 2010
Revise Financial Instructions and Accounting Manual	March 2011
Introduction of a new Public Finance Law	September 2011
Review the Accounting Standards of Financial Statement to follow International Public Sector Accounting Standards (IPSAS)	September 2011
Build capacity in the Ministry of Finance to analyze capital expenditure proposals	2010-11
Tax Reforms	
Set up an audit group to focus on large taxpayers	July 2010
Submit a new Customs Management Act to National Assembly	September 2010
Increase GST on tourism to 12%	November 2010
Public Enterprise Reform	
Commission external financial audit of DBS and HFC	June 2010
Engage FIRST Initiative on strategic options assessment of DBS and HFC	July 2010
Engagement of IFC to advise on the government's options on Nouvobanq	August 2010
Implementation plan in response to external strategic assessment of Air Seychelles	October 2010
Commission a comprehensive study of the tariff structure, production costs, and quality of service provision in the utilities sector	2010
Implement completed reform action plans for major public enterprises	2010–11
CBS Governance and Capitalization	
Present Electronic Clearing and Settlement System Bill to National Assembly	June 2010
Produce financial survey encompassing bank and nonbank financial institutions	December 2010
Introduce integrated IT-based accounting framework at CBS (core banking system)	December 2010
Introduce a business continuity plan at CBS	December 2010
Adopt a crisis preparedness plan for financial system	December 2010
Progressively raise capitalization of CBS to 10 percent of monetary liabilities	December 2010
Gradually raise minimum capital requirements for domestic banks.	2010–12

Implementation of real time gross settlement system.	2011–12
National Statistics	
Adopt a strategic plan to upgrade national statistics	September 2010
Implement Balance of Payments and International Investment Position Manual 6	2011
Implement SDDS	2011

ATTACHMENT II

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 (SMEFP), 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 are listed in Tables 1 and 2 of the SMEFP, 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 assets, free of any pledges or encumberments 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.

Adjusters

4. The floor on the CBS's NIR will be adjusted upward (downward) by the amount by which the external nonproject loans and cash grants exceeds (falls short of) the amounts assumed in the program (SMEFP 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

5. 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.

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

6. 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)

7. 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.

8. For the purpose of this performance criterion, external debt is defined as foreign currency denominated debt, and 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;

(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; and

(iv) 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

9. 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

10. 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

11. 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 four 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 two 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.

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.